DESCRIPTION OF SENATE FINANCE COMMITTEE CHAIRMAN'S MARK RELATING TO REVENUE RECONCILIATION PROVISIONS

Scheduled for Markup

Before the

SENATE COMMITTEE ON FINANCE

on June 19, 1997

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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JCX-29-97

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup of revenue reconciliation provisions, beginning on June 19, 1997. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's mark for the revenue reconciliation provisions: (I) family tax relief; (II) savings and investment tax incentives; (III) education tax incentives; (IV) estate, gift, and generation-skipping tax provisions; (V) extension of certain expiring tax provisions; (VI) District of Columbia tax incentives; (VII) miscellaneous provisions; and (VIII) revenue-increase provisions.

Separate documents provide descriptions of tax simplification and technical correction provisions of the Chairman's mark. Also, a separate document contains estimated budget effects of the revenue reconciliation, tax simplification, and technical correction provisions.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Senate Finance Committee Chairman's Mark Relating to Revenue Reconciliation Provisions* (JCX-29-97), June 17, 1997.

I. FAMILY TAX RELIEF

A. Child Tax Credit For Children Under Age 17

Present Law

In general

Present law does not provide tax credits based solely on the taxpayer's number of dependent children. Taxpayers with dependent children, however, generally are able to claim a personal exemption for each of these dependents. The total amount of personal exemptions is subtracted (along with certain other items) from adjusted gross income ("AGI") in arriving at taxable income. The amount of each personal exemption is $2,650 for 1997, and is adjusted annually for inflation. In 1997, the amount of the personal exemption is phased out for taxpayers with AGI in excess of $121,200 for single taxpayers, $151,500 for heads of household, and $181,800 for married couples filing joint returns. These phaseout thresholds are adjusted annually for inflation.

Description of Proposal

The proposal would allow taxpayers a maximum nonrefundable tax credit of $500 (pro rata amount of $250 in 1997 for children under the age of 13) for each qualifying child under the age of 17. For taxable years beginning after December 31, 2002, the credit would be allowed for each qualifying child under the age of 18. A qualifying child would be defined as an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or a descendent of either), a stepson or stepdaughter of the taxpayer or an eligible foster child of the taxpayer. The credit amount would not be indexed for inflation.

In the case of each child age 13 to 16 (13 to 17 for taxable years beginning after December 31, 2002), the credit would be available only for amounts contributed to savings for education with respect to that child. Specifically, the credit would be allowed only if an amount at least equal to the amount of the credit is deposited into a qualified tuition program or an education IRA (as described below) before April 15 of the year following the year with respect to which the credit is claimed. Any amounts withdrawn within one year of the last day for qualified deposits would be subject to a 100-percent recapture.

For taxpayers with AGI in excess of certain thresholds, the otherwise allowable child credit would be phased out. Specifically, the otherwise allowable child credit would be reduced by $25 for each $1,000 of AGI (or fraction thereof) in excess of the threshold ("the AGI phase-out"). For these purposes modified AGI would be computed by increasing the taxpayer's AGI by the amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively). For married taxpayers filing joint returns, the threshold would be $110,000. For taxpayers filing single or head of household returns, the threshold would be $75,000. For married taxpayers filing separate returns, the threshold would be $55,000. These thresholds would not be indexed for inflation.

The maximum amount of the child credit for each taxable year could not exceed an amount equal to the excess of: (1) the taxpayer's regular income tax liability (net of applicable credits) over (2) the sum of the taxpayer's tentative minimum tax liability (determined without regard to the alternative minimum foreign tax credit) and the earned income credit allowed.

Effective Date

The child tax credit would be effective July 1, 1997 for taxable years beginning after December 31, 1996.

B. Increase Exemption Amounts Applicable to Individual Alternative Minimum Tax

Present Law

Present law imposes a minimum tax on an individual to the extent the taxpayer's minimum tax liability exceeds his or her regular tax liability. This alternative minimum tax is imposed upon individuals at rates of (1) 26 percent on the first $175,000 of alternative minimum taxable income in excess of a phased-out exemption amount and (2) 28 percent on the amount in excess of $175,000. The exemption amounts are $45,000 in the case of married individuals filing a joint return and surviving spouses; $33,750 in the case of other unmarried individuals; and $22,500 in the case of married individuals filing a separate return. These exemption amounts are phased-out by an amount equal to 25 percent of the amount that the individual's alternative minimum taxable income exceeds a threshold amount. These threshold amounts are $150,000 in the case of married individuals filing a joint return and surviving spouses; $112,500 in the case of other unmarried individuals; and $75,000 in the case of married individuals filing a separate return, estates, and trusts. The exemption amounts, the threshold phase-out amounts, and the $175,000 break-point amount are not indexed for inflation.

Description of Proposal

For taxable years beginning after 2000 and before 2003, the exemption amounts of the individual alternative minimum tax would be increased as follows in each year: (1) by $600 in the case of married individuals filing a joint return and surviving spouses; (2) by $450 in the case of other unmarried individuals; and (3) by $300 in the case of married individuals filing separate returns.

For taxable years beginning after 2002, the exemption amount of the individual alternative minimum tax would be increased as follows in each year: (1) by $950 in the case of married individuals filing a joint return and surviving spouses; (2) by $700 in the case of other unmarried individuals; and (3) by $475 in the case of married individuals filing separate returns.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

II. EDUCATION TAX INCENTIVES

A. Tax Benefits Relating to Education Expenses

1. HOPE credit for higher education tuition expenses

<u>**Present Law**</u>

<u>**Deductibility of education expenses**</u>

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5). However, education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses meet the above-described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's adjusted gross income (AGI).

<u>**Exclusion for employer-provided educational assistance**</u>

A special rule allows an employee to exclude from gross income for income tax purposes and from wages for employment tax purposes up to $5,250 annually paid by his or her employer for educational assistance (sec. 127). In order for the exclusion to apply certain requirements must be satisfied, including a requirement that not more than 5 percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than 5-percent owners of the employer and the spouses or dependents of such more than 5-percent owners. This special rule for employer-provided educational assistance expires with respect to courses beginning after June 30, 1997 (and does not apply to graduate level courses beginning after June 30, 1996).

For purposes of the special exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include tools or supplies which may be retained by the employee after completion of a course or meals, lodging, or transportation. The exclusion does not apply to any education involving sports, games, or hobbies.

In the absence of the special exclusion, employer-provided educational assistance is excludable from gross income and wages as a working condition fringe benefit (sec. 132(d)) only to the extent the education expenses would be deductible under section 162.

Exclusion for interest earned on savings bonds

Another special rule (sec. 135) provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[2] "Qualified higher education expenses" include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools. The exclusion provided by section 135 is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 1996, the exclusion was phased out for taxpayers with modified AGI between $49,450 and $64,450 ($74,200 and $104,200 for joint returns). To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds directly in the child's name, section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

Qualified scholarships

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. There is, however, no dollar limitation for the section 117 exclusion, provided that the scholarship funds are used to pay for tuition and required fees. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for education below the graduate level provided to employees of certain educational organizations. Section 117(c) specifically provides that the exclusion for qualified scholarships does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship.

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[2] If the aggregate redemption amount (i.e., principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses incurred, then the excludable portion of interest income is based on the ratio that the education expenses bears to the aggregate redemption amount (sec. 135(b)).

Student loan forgiveness

In the case of an individual, section 108(f) provides that gross income subject to Federal income tax does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers (e.g., providing health care services to a nonprofit organization). Student loans eligible for this special rule must be made to an individual to assist the individual in attending an education institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses (in contrast to tax-free scholarships under section 117, which are limited to tuition and required fees). In addition, the loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation. Thus, loans made with private, nongovernmental funds are not qualifying student loans for purposes of the section 108(f) exclusion. As with section 117, there is no dollar limitation for the section 108(f) exclusion.

Qualified State prepaid tuition programs

Section 529 (enacted as part of the Small Business Job Protection Act of 1996) provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. "Qualified higher education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). Qualified higher education expenses do not include room and board expenses. Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person.[3]

Description of Proposal

In general

Individual taxpayers would be allowed to claim a non-refundable HOPE credit against Federal income taxes up to $1,500 per student per year for 50 percent of qualified tuition and related expenses (but not room and board expenses) paid for the first two years of the student's post-secondary education in a degree or certificate program. In the case of a student attending a two-year community college or vocational/technical school, the maximum HOPE credit would equal 75 percent (rather than 50 percent) of qualified tuition and related expenses, subject to a maximum credit of $1,500 per student per year.[4] The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent. The HOPE credit would be available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education. Beginning in 1998, the maximum HOPE credit amount of $1,500 would be indexed for inflation, rounded down to the closest multiple of $50.[5]

The HOPE credit amount that a taxpayer could otherwise claim would be phased out ratably for taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). Modified AGI would include amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions). Beginning in 2001, the income phase-out ranges would be indexed for inflation, rounded down to the closest multiple of $5,000.

The HOPE credit would be available in the taxable year the expenses are paid, subject to the requirement that the education commence or continue during that year or during the first

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[3] Specifically, section 529(c)(3)(A) provides that any distribution under a qualified State tuition program shall be includible in the gross income of the distributee in the same manner as provided under present-law section 72 to the extent not excluded from gross income under any other provision of the Code.

[4] Thus, students attending two-year community colleges or vocational/technical schools could be eligible for the $1,500 maximum HOPE credit if they incur $2,000 of qualified tuition and related expenses. In contrast, students attending other institutions (e.g., four-year colleges) could be eligible for the $1,500 maximum HOPE credit if they incur $3,000 of qualified tuition and related expenses.

[5] The HOPE credit could not be claimed against a taxpayer's alternative minimum tax (AMT) liability.

three months of the next year. Qualified tuition expenses paid with the proceeds of a loan generally would be eligible for the HOPE credit (rather than repayment of the loan itself).[6]

Dependent students

A taxpayer could claim the HOPE credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases where the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent by the parent or other taxpayer, the eligible student him- or herself would not be entitled to claim a HOPE credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student would be treated as paid by the parent (or other taxpayer) for purposes of the proposal.

Election of HOPE credit or proposed exclusion for distributions from a qualified tuition program or education IRA

For each taxable year, a taxpayer may elect with respect to an eligible student either the HOPE credit (assuming that all the requirements of the HOPE credit are satisfied) or the proposed exclusion for distributions from a qualified tuition program or education IRA used to cover qualified higher education expenses (described below).[7] If a child is not claimed as a dependent by the parent (or by any other taxpayer) for the taxable year, then the child him- or herself will have the option of electing either the HOPE credit or proposed exclusion for distributions from a qualified tuition program or education IRA used to cover qualified higher education expenses.

Qualified tuition and related expenses

The HOPE credit would be available for "qualified tuition and related expenses," meaning tuition, fees, and books required for the enrollment or attendance of an eligible student at an eligible educational institution. Charges and fees associated with meals, lodging, student

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[6] The Treasury Department would have authority to issue regulations providing that the HOPE credit would be recaptured in cases where the student or taxpayer receives a refund of tuition and related expenses with respect to which a credit was claimed in a prior year.

[7] For any taxable year, a taxpayer may claim the HOPE credit for qualified tuition and related expenses paid with respect to one student and also claim the proposed exclusion for distributions made from a qualified tuition program or education IRA (described below) used to cover higher education expenses paid with respect to one or more other students. If the HOPE credit is claimed with respect to one student for one or two taxable years, then the proposed exclusion for distributions from a qualified tuition program or education IRA may be claimed with respect to that same student for subsequent taxable years.

activities, athletics, insurance, transportation, and similar personal, living or family expenses would not be included. The expenses of education involving sports, games, or hobbies would not be qualified tuition expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally would include only out-of-pocket expenses. Qualified tuition expenses would not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total tuition and related expenses would be reduced by scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under section 127. No reduction of qualified tuition expenses would be required for a gift, bequest, devise, or inheritance within the meaning of section 102(a). Under the proposal, a HOPE credit would not be allowed with respect to any education expenses for which a deduction is claimed under section 162 or any other section of the Code.[8]

Eligible student

An eligible student would be one who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. (In other words, for at least one academic period which begins during the taxable year, the student must carry at least one-half the normal full-time work load for the course of study the student is pursuing.) An eligible student would be required to have earned a high-school diploma (or equivalent degree) prior to attending any post-secondary classes with respect to which a HOPE credit is claimed. An eligible student could not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institution

Under the proposal, eligible educational institutions would be defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally would be accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also would be eligible educational institutions. The institution must be eligible to participate in Department of Education student aid programs.

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[8] In addition, the proposal would amend present-law section 135 to provide that the amount of qualified higher education expenses taken into account for purposes of that section would be reduced by the amount of such expenses taken into account in determining the HOPE credit allowed to any taxpayer with respect to the student for the taxable year.

Regulations

The Secretary of the Treasury (in consultation with the Secretary of Education) would have authority to issue regulations to implement the proposal, including regulations providing appropriate rules for recordkeeping and information reporting. These regulations would address the information reports that eligible educational institutions would be required to file to assist students and the IRS in calculating the amount of the HOPE credit potentially available. Where certain terms are defined by reference to the Higher Education Act of 1965, the Secretary of Education would have authority to issue regulations, as well as authority to define other education terms as necessary.

Effective Date

The proposal would be effective for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date.

2. Exclusion from gross income for amounts distributed from qualified tuition programs and education IRAs to cover qualified higher education expenses

Present Law

Deductibility of education expenses

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5). However, education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses meet the above-described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's adjusted gross income (AGI).

Exclusion for employer-provided educational assistance

A special rule allows an employee to exclude from gross income for income tax purposes and from wages for employment tax purposes up to $5,250 annually paid by his or her employer for educational assistance (sec. 127). In order for the exclusion to apply certain requirements must be satisfied, including a requirement that not more than 5 percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than 5-percent owners of the employer and the spouses or dependents of such more than 5-percent owners. This special rule for employer-provided educational assistance expires with respect to courses beginning after June 30, 1997 (and does not apply to graduate level courses beginning after June 30, 1996).

For purposes of the special exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include tools or supplies which may be retained by the employee after completion of a course or meals, lodging, or transportation. The exclusion does not apply to any education involving sports, games, or hobbies.

In the absence of the special exclusion, employer-provided educational assistance is excludable from gross income and wages as a working condition fringe benefit (sec. 132(d)) only to the extent the education expenses would be deductible under section 162.

<u>**Exclusion for interest earned on savings bonds**</u>

Another special rule (sec. 135) provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[9] "Qualified higher education expenses" include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools. The exclusion provided by section 135 is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 1996, the exclusion was phased out for taxpayers with modified AGI between $49,450 and $64,450 ($74,200 and $104,200 for joint returns). To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds directly in the child's name, section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

<u>**Qualified scholarships**</u>

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the

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[9] If the aggregate redemption amount (i.e., principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses incurred, then the excludable portion of interest income is based on the ratio that the education expenses bears to the aggregate redemption amount (sec. 135(b)).

enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. There is, however, no dollar limitation for the section 117 exclusion, provided that the scholarship funds are used to pay for tuition and required fees. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for education below the graduate level provided to employees of certain educational organizations. Section 117(c) specifically provides that the exclusion for qualified scholarships does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship.

Student loan forgiveness

In the case of an individual, section 108(f) provides that gross income subject to Federal income tax does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers (e.g., providing health care services to a nonprofit organization). Student loans eligible for this special rule must be made to an individual to assist the individual in attending an education institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses (in contrast to tax-free scholarships under section 117, which are limited to tuition and required fees). In addition, the loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation. Thus, loans made with private, nongovernmental funds are not qualifying student loans for purposes of the section 108(f) exclusion. As with section 117, there is no dollar limitation for the section 108(f) exclusion.

Qualified State prepaid tuition programs

Section 529 (enacted as part of the Small Business Job Protection Act of 1996) provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. "Qualified higher education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). Qualified higher education expenses do not include room and board expenses. Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person.[10]

Contributions made to a qualified State tuition program are treated as incomplete gifts for Federal gift tax purposes (sec. 529(c)(2)). Thus, any Federal gift tax consequences are determined at the time that a distribution is made from an account under the program. The waiver (or payment) of qualified higher education expenses of a designated beneficiary by (or to) an educational institution under a qualified State tuition program is treated as a qualified transfer for purposes of present-law section 2503(e). Amounts contributed to a qualified State tuition program (and earnings thereon) are includible in the contributor's estate for Federal estate tax purposes in the event that the contributor dies before such amounts are distributed under the program (sec. 529(c)(4)).

Individual retirement arrangements ("IRAs")

An individual may make deductible contributions to an individual retirement arrangement ("IRA") for each taxable year up to the lesser of $2,000 or the amount of the individual's compensation for the year if the individual is not an active participant in an employer-sponsored qualified retirement plan (and, if married, the individual's spouse also is not an active participant). Contributions may be made to an IRA for a taxable year up to April 15th of the following year. An individual who makes excess contributions to an IRA, i.e., contributions in excess of $2,000, is subject to an excise tax on such excess contributions unless they are distributed from the IRA before the due date for filing the individual's tax return for the year (including extensions). If the individual (or his or her spouse, if married) is an active participant, the $2,000 limit is phased out between $40,000 and $50,000 of adjusted gross income ("AGI") for married couples and between $25,000 and $35,000 of AGI for single individuals.

[10] Specifically, section 529(c)(3)(A) provides that any distribution under a qualified State tuition program shall be includible in the gross income of the distributee in the same manner as provided under present-law section 72 to the extent not excluded from gross income under any other provision of the Code.

Present law permits individuals to make nondeductible contributions (up to $2,000 per year) to an IRA to the extent an individual is not permitted to (or does not) make deductible contributions. Earnings on such contributions are includible in gross income when withdrawn.

An individual generally is not subject to income tax on amounts held in an IRA, including earnings on contributions, until the amounts are withdrawn from the IRA. Amounts withdrawn from an IRA are includible in gross income (except to the extent of nondeductible contributions). In addition, a 10-percent additional tax generally applies to distributions from IRAs made before age 59-1/2, unless the distribution is made (1) on account of death or disability, (2) in the form of annuity payments, (3) for medical expenses of the individual and his or her spouse and dependents that exceed 7.5 percent of AGI, or (4) for medical insurance of the individual and his or her spouse and dependents (without regard to the 7.5 percent of AGI floor) if the individual has received unemployment compensation for at least 12 weeks, and the withdrawal is made in the year such unemployment compensation is received or the following year.

Description of Proposal

In general

Amounts distributed from qualified tuition programs or certain education investment accounts (referred to as an "education IRAs") to cover qualified higher education expenses of an eligible student would be excludable from gross income.[11] An exclusion would not be allowed under the proposal with respect to an otherwise eligible student if the proposed HOPE credit (as described previously) is claimed with respect to that student for the taxable year the distribution is made.[12]

Eligible students

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[11] The exclusion would not be a preference item for alternative minimum tax (AMT) purposes.

[12] To the extent that distributions from a qualified tuition program or education IRA exceed qualified higher education expenses paid on behalf of an eligible student during the year, or if the HOPE credit is claimed with respect to the student for the year, then such distributions would be includible in the gross income of the distributee in the same manner as provided under present-law section 72 (to the extent not excluded under any other section).

If a HOPE credit was claimed with respect to a student for an earlier taxable year (i.e., the student's first or second year of post-secondary education), the proposed exclusion still could be claimed with respect to that student for a subsequent taxable year.

To be an eligible student under the proposal, an individual would have to be at least a half-time student in a degree or certificate undergraduate or graduate program at an eligible educational institution. For this purpose, a student would be at least a half-time student if he or she is carrying at least one-half the normal full-time work load for the course of study the student is pursuing. An eligible student could not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institution

Under the proposal, eligible educational institutions would be defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally would be accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also would be eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

Qualified higher education expenses

Under the proposal, the definition of "qualified higher education expenses" would include tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a student at an eligible education institution, as well as room and board expenses (meaning the minimum room and board allowance applicable to the student as determined by the institution in calculating costs of attendance for Federal financial aid programs under sec. 472 of the Higher Education Act of 1965) for any period during which the student is at least a half-time student. Qualified higher education expenses could include expenses with respect to undergraduate or graduate-level courses.

Qualified higher education expenses generally would include only out-of-pocket expenses. Qualified higher education expenses would not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified higher education expenses would be reduced by scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under section 127. In addition, qualified higher education expenses would not include expenses paid with amounts that are excludible under section 135. No reduction of qualified higher education expenses would be required for a gift, bequest, devise, or inheritance within the meaning of section 102(a). If education expenses for a taxable year are deducted under section 162 or any other section of the Code, then such expenses would not be qualified higher education expenses under the proposal.

Qualified tuition programs and education IRAs

Under the proposal, a "qualified tuition program" would mean any qualified State tuition program, generally as defined under present-law section 529, as well as any program established and maintained by one or more eligible educational institutions (which could be private institutions) that satisfy the requirements under section 529 (other than present-law State ownership rule). An "education IRA" would mean a trust which is created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of the account holder and which satisfies certain other requirements.

Contributions to qualified tuition programs or education IRAs could be made only in cash.[13] Such contributions could not be made after the designated beneficiary or account holder reaches age 18. Annual contributions to a qualified tuition program not maintained by a State (i.e., a qualified tuition program operated by one or more private schools) or to an education IRA would be limited to $2,000 per beneficiary or account holder.[14] In the case of any child with respect to whom the proposed child care credit (as described above) is allowed for the taxable year, the annual contribution limit on behalf of that child would be increased by the amount of the child care credit (i.e., the contribution limit for the year with respect to such a child could be as much as $2,500).[15] Generally, in order to enforce the annual contribution limit, no more than

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[13] The proposal would allow taxpayers to redeem U.S. Savings Bonds and be eligible for the exclusion under section 135 (as if the proceeds were used to pay qualified higher education expenses) if the proceeds from the redemption are contributed to a qualified tuition program or education IRA on behalf of the taxpayer, the taxpayer's spouse, or a dependent. In such a case, the beneficiary's or account holder's basis in the bond proceeds contributed on his or her behalf to the qualified tuition program or education IRA would be the contributor's basis in the bonds (i.e., the original purchase price paid by the contributor for such bonds).

The proposal also would provide that funds from an education IRA would be deemed to be distributed to pay qualified higher education expenses if the funds are used to make contributions to (or purchase tuition credits from) a qualified tuition program for the benefit of the account holder.

[14] State-sponsored qualified tuition programs will continue to be governed by the rule contained in present-law section 529(b)(7) that such programs provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary. State-sponsored qualified tuition programs will not be subject to a specific dollar cap under section 529 on annual contributions that can be made under the program on behalf of a designated beneficiary.

[15] The maximum contribution limit for the year would be increased even if the child is younger than age 13--that is, even in cases where the parent is not required (under the proposal described previously) but may elect to deposit an amount equal to the child credit into a qualified tuition program or education IRA on behalf of the child.

one education investment account or qualified tuition account could be maintained to benefit any one beneficiary.[16]

Any balance remaining in a qualified tuition program or education IRA must be distributed when the beneficiary or account holder becomes 30 years old (or dies). Such a distribution could include a tax-free rollover of the amounts in the qualified tuition program or education investment account into an individual retirement arrangement (IRA) established on behalf of the beneficiary of the qualified tuition program or education IRA. In addition, transfers or rollovers of credits or account balances from one account benefiting one beneficiary to another account benefiting another beneficiary would not be considered a distribution from a qualified tuition program or education IRA (nor would a change in the designated beneficiary or account holder) if the new beneficiary is a member of the family of the old beneficiary.[17]

Qualified tuition programs and education IRAs (as separate legal entities) would be exempt from Federal income tax, other than taxes imposed under the present-law unrelated business income tax (UBIT) rules.[18]

Under the proposal, a 10-percent penalty tax would be imposed on distributions from qualified tuition programs or education IRAs to the extent the distribution exceeds qualified higher education expenses paid by the taxpayer (and is not made on account of the death, disability, or scholarship received by the designated beneficiary or account holder).

Estate and gift tax treatment

Contributions to qualified tuition programs and education IRAs would not be considered taxable gifts for Federal gift tax purposes. For estate tax purposes, the value of any interest in a qualified tuition program or education IRA would be includible in the estate of the designated beneficiary. In no event would such an interest be includible in the estate of the contributor.

Effective Date

The proposal generally would be effective for distributions made, and qualified higher education expenses paid, after December 31, 1997, for education furnished in academic periods

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[16] To the extent contributions exceed the $2,000 annual limit, an excise tax penalty may be imposed on the contributor under present-law section 4973, unless the excess contributions (and any earnings thereon) are returned to the contributor before the due date for the return for the taxable year during which the excess contribution is made.

[17] For this purpose, a "member of the family" means persons described in paragraphs (1) through (8) of section 152(a), and any spouse of such persons.

[18] An interest in a qualified tuition program or education IRA would not be treated as debt for purposes of the debt-financed property UBIT rules of section 514.

beginning after such date. The provisions governing contributions to, and the tax-exempt status of, qualified tuition plans and education IRAs generally would be effective after December 31, 1997. The gift tax provisions would be effective for contributions (or transfers) made after the date of enactment, and the estate tax provisions would be effective for decedents dying after June 16, 1997.

3. Deduction for student loan interest

Present Law

The Tax Reform Act of 1986 repealed the deduction for personal interest. Student loan interest generally is treated as personal interest and thus is not allowable as an itemized deduction from income.

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5). Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses relate to the employee's current job and only to the extent that the expenses, along with other miscellaneous deductions, exceed two percent of the taxpayer's adjusted gross income (AGI).

Description of Proposal

Under the proposal, certain individuals who have paid interest on qualified education loans would be allowed to claim an above-the-line deduction for such interest expenses, up to a maximum deduction of $2,500 per year. The deduction would be allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Months during which the qualified education loan is in deferral or forbearance would not count against the 60-month period. No deduction would be allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year. Beginning in 1998, the maximum deduction of $2,500 would be indexed for inflation, rounded down to the closest multiple of $50.

A qualified education loan generally would be defined as any indebtedness incurred to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. Qualified higher education expenses would be defined as the student's cost of attendance as defined in section 472 of the Higher Education Act of 1965 (generally, tuition, fees, room and board, and related expenses), reduced by (1) any amount excluded from gross income under section 135 (i.e., United States savings bonds used to pay higher education tuition and fees), (2) any amount distributed from a qualified tuition program or education investment account and excluded from gross income (under the proposal described above), and (3) the amount of any scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under section 127. Such expenses must be paid or incurred within a reasonable period before or after the indebtedness is incurred, and must be attributable to a period when the student is at least a half-time student.

The deduction would be phased out ratably for taxpayers with modified adjusted gross income (AGI) between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). Modified AGI would include amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions. Beginning in 2001, the income phase-out ranges would be indexed for inflation, rounded down to the closest multiple of $5,000.

Any person in a trade or business or any governmental agency that receives $600 or more in qualified education loan interest from an individual during a calendar year would be required to provide an information report on such interest to the IRS and to the payor.

Effective Date

The proposal would be effective for payments of interest due after December 31, 1996, on any qualified education loan. Thus, in the case of already existing qualified education loans, interest payments would qualify for the deduction to the extent that the 60-month period has not expired. For purposes of counting the 60 months, any qualified education loan and all refinancing (that is treated as a qualified education loan) of such loan would be treated as a single loan.

4. Penalty-free withdrawals from IRAs for higher education expenses

Present Law

An individual may make deductible contributions to an individual retirement arrangement ("IRA") for each taxable year up to the lesser of $2,000 or the amount of the individual's compensation for the year if the individual is not an active participant in an employer-sponsored qualified retirement plan (and, if married, the individual's spouse also is not an active participant). In the case of a married couple, deductible IRA contributions of up to $2,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the $2,000 deduction limit is phased out over certain adjusted gross income ("AGI") levels. The limit is phased out between $40,000 and $50,000 of AGI for married taxpayers, and between $25,000 and $35,000 of AGI for single taxpayers. An individual may make nondeductible IRA contributions to the extent the individual is not permitted to make deductible IRA contributions. Contributions cannot be made to an IRA after age 70-1/2.

Amounts held in an IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts withdrawn prior to attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of AGI, or is used to purchase health insurance of an unemployed individual.

Description of Proposal

The proposal would provide that the 10-percent early withdrawal tax does not apply to distributions from IRAs (including IRA PLUSs) if the taxpayer uses the amounts to pay qualified higher education expenses (including those related to graduate level courses) of the taxpayer, the taxpayer's spouse, or any child, or grandchild of the individual or the individual's spouse.

The penalty-free withdrawal would be available for "qualified higher education expenses," meaning tuition, fees, books, supplies, equipment required for enrollment or attendance, and room and board at a post-secondary educational institution (defined by reference to sec 481 of the Higher Education Act of 1965). Qualified higher education expenses would be reduced by any amount excludable from gross income under section 135 relating to the redemption of a qualified U.S. savings bond and certain scholarships and veterans benefits.

Effective Date

The proposal would be effective for distributions after December 31, 1997, with respect to expenses paid after such date for education furnished in academic periods beginning after such date.

B. Other Education-Related Tax Provisions

1. Extension of exclusion for employer-provided educational assistance

Present Law

Under present law, an employee's gross income and wages do not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts are paid or incurred pursuant to an educational assistance program that meets certain requirements. This exclusion is limited to $5,250 of educational assistance with respect to an individual during a calendar year. The exclusion does not apply to graduate level courses beginning after June 30, 1996. The exclusion expires with respect to courses beginning after June 30, 1997.[19] In the absence of the exclusion, educational assistance is excludable from income only if it is related to the employee's current job.

Description of Proposal

The proposal would permanently extend the exclusion for employer-provided educational assistance. Beginning in 1997, the exclusion would apply to graduate-level courses as well as undergraduate courses.

Effective Date

The extension of the exclusion with respect to undergraduate courses would apply to taxable years beginning after December 31, 1996. The extension of the exclusion to graduate-level courses would apply to courses of instruction beginning after December 31, 1996.

2. Modification of $150 million limit on qualified 501(c)(3) bonds other than hospital bonds

Present Law

Interest on State and local government bonds generally is excluded from income if the bonds are issued to finance activities carried out and paid for with revenues of these governments. Interest on bonds issued by these governments to finance activities of other persons, e.g., private activity bonds, is taxable unless a specific exception is included in the Code. One such exception is for private activity bonds issued to finance activities of private, charitable organizations described in Code section 501(c)(3) ("section 501(c)(3) organizations") when the activities do not constitute an unrelated trade or business.

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[19] The legislative history reflects congressional intent that the provision expire with respect to courses beginning after May 31, 1997.

Present law treats section 501(c)(3) organizations as private persons; thus, bonds for their use may only be issued as private activity "qualified 501(1)(3) bonds," subject to the restrictions of Code section 145. The most significant of these restrictions limits the amount of outstanding bonds from which a section 501(c)(3) organization may benefit to $150 million. In applying this "$150 million limit," all section 501(c)(3) organizations under common management or control are treated as a single organization. The limit does not apply to bonds for hospital facilities, defined to include only acute care, primarily inpatient, organizations.

Description of Proposal

The $150 million limit would be repealed for bonds issued after the date of enactment to finance capital expenditures incurred after date of the enactment.

Effective Date

The proposal would be effective for bonds issued after the date of enactment to finance capital expenditures incurred after the date of enactment.

3. Certain teacher education expenses not subject to 2 percent limit on miscellaneous itemized deductions

Present Law

In general, taxpayers are not permitted to deduct education expenses. However, employees may deduct the cost of certain work-related education. For costs to be deductible, the education must either be required by the taxpayer's employer or by law to retain taxpayer's current job or be necessary to maintain or improve skills required in the taxpayer's current job. Expenses incurred for education that is necessary to meet minimum education requirements of an employee's present trade or business or that can qualify an employee for a new trade or business are not deductible.

An employee can deduct educational expenses only to the extent such expenses (together with other miscellaneous itemized deductions) exceed 2 percent of the taxpayer's adjusted gross income.

Description of Proposal

Under the proposal, any expenses incurred by a teacher of students in grades K-12 in obtaining training in education technology that are deductible education expenses under present law would not be subject to the 2 percent floor on miscellaneous itemized deductions.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

4. Expansion of arbitrage rebate exception for certain bonds

Present Law

Generally, all arbitrage profits earned on investments unrelated to the purpose of the borrowing ("nonpurpose investments") when such earnings are permitted must be rebated to the Federal Government.

An exception is provided for bonds issued by governmental units having general taxing powers if the governmental unit (and all subordinate units) issues $5 million or less of governmental bonds during the calendar year ("the small-issuer exception"). This exception does not apply to private activity bonds.

Description of Proposal

The proposal would provide that up to $5 million dollars of bonds used to finance public school capital expenditures incurred after December 31, 1997, would be excluded from application of the present-law $5 million limit. Thus, small issuers could continue to benefit from the small issue exception from arbitrage rebate if they issue no more than $10 million in governmental bonds per calendar year and no more than $5 million of the bonds is used to finance expenditures other than for public school capital expenditure.

Effective Date

The proposal would be effective for bonds issued after December 31, 1997.

III. SAVINGS AND INVESTMENT TAX INCENTIVES

A. Capital Gains Provisions

1. Maximum rate of tax on net capital gain of individuals

Present Law

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of capital assets, the net capital gain is taxed at the same rate as ordinary income, except that individuals are subject to a maximum marginal rate of 28 percent of the net capital gain. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) certain U.S. publications. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method of depreciation.

Description of Proposal

The proposal generally would reduce the maximum rate of tax on the net capital gain of an individual from 28 percent to 20 percent. Net capital gain presently taxed to an individual at a 15-percent rate would be taxed at a 10 percent rate. These rates also would apply for purposes of the alternative minimum tax.

The tax on the net capital gain attributable to any long-term capital gain from the sale or exchange of collectibles would remain at maximum rate of 28 percent; and any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real property) which would be treated as ordinary income if the property were section 1245 property (i.e. depreciable personal property) would be taxed at a maximum rate of 26 percent.

Effective Date

The proposal would apply to taxable years ending after May 6, 1997. For a taxable year which includes May 7, 1997, only the net capital gain attributable to gain or loss properly taken into account for the portion of the taxable year on or after May 7, 1997, would be entitled to the lower tax rates.

2. Small business stock

Present Law

The Revenue Reconciliation Act of 1993 provided individuals a 50-percent exclusion for the sale of certain small business stock acquired at original issue and held for at least five years. One-half of the excluded gain is a minimum tax preference.

The amount of gain eligible for the 50-percent exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) $10 million.

In order to qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million. The corporation also must meet an active trade or business requirement.

Description of Proposal

Under the proposal, the 50-percent exclusion would apply to small business stock (other than stock of a subsidiary corporation) held by a corporation. The minimum tax preference would be repealed. Under the proposal, in the case of qualifying sale of small business stock by an individual, the maximum rate of tax (taking together the 50-percent exclusion and the maximum 20-percent capital gains rate added by the proposal) would be 10 percent.

The proposal would increase the size of an eligible corporation from gross assets of $50 million to gross assets of $100 million. The proposal would also repeal the limitation on the amount of gain an individual can exclude with respect to the stock of any corporation.

The proposal would provide that certain working capital must be expended within five years (rather than two years) in order to be treated as used in the active conduct of a trade or business. No limit on the percent of the corporation's assets that are working capital would be imposed.

The proposal would provide that if the corporation establishes a business purpose for a redemption of its stock, that redemption is disregarded in determining whether other newly issued stock could qualify as eligible stock.

The proposal would allow a taxpayer to rollover gain from the sale or exchange of small business stock held more than 5 years where the taxpayer uses the proceeds to purchase other small business stock within 60 days of the sale of the original stock. Gain from the sale of the replacement stock would be treated as gain from the sale or exchange of small business stock held more than 5 years to the extent of the gain that is rolled-over. Also any gain in the replacement stock could be rolled over.

Effective Date

The increase in the size of corporations whose stock is eligible for the exclusion and the application of these proposals to stock held by a corporation would apply to stock issued after the date of the enactment of the proposal. The remaining provisions would apply to stock issued after August 10, 1993 (the original effective date of the small business stock provision).

3. Exclusion of gain on sale of principal residence

Present Law

Rollover of gain

No gain is recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence is purchased and used by the taxpayer as his or her principal residence within a specified period of time (sec. 1034). This replacement period generally begins two years before and ends two years after the date of sale of the old residence. The basis of the replacement residence is reduced by the amount of any gain not recognized on the sale of the old residence by reason of this gain rollover rule.

One-time exclusion

In general, an individual, on a one-time basis, may exclude from gross income up to $125,000 of gain from the sale or exchange of a principal residence if the taxpayer (1) has attained age 55 before the sale, and (2) has owned the property and used it as a principal residence for three or more of the five years preceding the sale (sec. 121).

Description of Proposal

A taxpayer generally would be able to exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion would be allowed each time a taxpayer selling or exchanging a principal residence meets the eligibility requirements, but generally no more frequently than once every two years. The proposal provides that gain would be recognized to the extent of any depreciation allowable with respect to the rental or business use of such principal residence for periods after May 6, 1997.

To be eligible for the exclusion, a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or other unforseen circumstances would be able to exclude the fraction of the $250,000

($500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met.

In the case of joint filers not sharing a principal residence, an exclusion of $250,000 would be available on a qualifying sale or exchange of the principal residence of one of the spouses. Similarly, if a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the marriage, the proposal would allow the newly married taxpayer a maximum exclusion of $250,000. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either of them, the taxpayers may exclude $500,000 of gain on their joint return.

Under the proposal, gain from the sale or exchange of a life estate or a remainder interest in the taxpayer's principal residence may qualify for the exclusion, but gain from only one disposition of such an interest in any residence by a taxpayer may qualify.

Effective Date

The proposal would be available for all sales or exchanges of a principal residence occurring on or after May 7, 1997, and would replace the present-law rollover and one-time exclusion provisions applicable to principal residences.

A taxpayer could elect to apply present law (rather than the new exclusion) to a sale or exchange (1) made before the date of enactment, (2) made after the date of enactment pursuant to a binding contract in effect on the date or (3) where the replacement residence was acquired on or before the date of enactment (or pursuant to a binding contract in effect of the date of enactment) and the rollover provision would apply. If a taxpayer acquired his or her current residence in a rollover transaction, periods of ownership and use of the prior residence would be taken into account in determining ownership and use of the current residence.

B. Individual Retirement Arrangements

Present Law

Under present law, an individual may make deductible contributions to an individual retirement arrangement ("IRA") up to the lesser of $2,000 or the individual's compensation if the individual is not an active participant in an employer-sponsored retirement plan (and, if married, the individual's spouse also is not an active participant in such a plan). If the case of a married couple, deductible IRA contributions of up to $2,000 can be made for each spouse (including, for example, a home maker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the $2,000 deduction limit is phased out over certain adjusted gross income ("AGI") levels. The limit is phased out between $40,000 and $50,000 of AGI for married taxpayers, and between $25,000 and $35,000 of AGI for single taxpayers. An individual may make nondeductible IRA contributions to the extent the individual is not permitted to make deductible IRA contributions. Contributions cannot be made to an IRA after age 70-1/2.

Amounts held in an IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts withdrawn prior to attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of AGI, or is used to purchase health insurance of an unemployed individual.

In general, distributions from an IRA are required to begin at age 70-1/2. An excise tax is imposed if the minimum required distributions are not made. Distributions to the beneficiary of an IRA are generally required to begin within 5 years of the death of the IRA owner, unless the beneficiary is the surviving spouse.

A 15-percent excise tax is imposed on excess distributions with respect to an individual during any calendar year from qualified retirement plans, tax-sheltered annuities, and IRAs. In general, excess distributions are defined as the aggregate amount of retirement distributions (i.e., payments from applicable retirement plans) made with respect to an individual during any calendar year to the extent such amounts exceed $160,000 (for 1997) or 5 times that amount in the case of a lump-sum distribution. The dollar limit is indexed for inflation. A similar 15-percent additional estate tax applies to excess retirement accumulations upon the death of the individual. The 15-percent tax on excess distributions (but not the 15-percent additional estate tax) does not apply to distributions in 1997, 1998 or 1999.

IRAs may not be invested in collectibles. A collectible is defined as any piece of art, rug or antique, metal or gem, stamp or coin, alcoholic beverage, or other personal property as specified by the Treasury. This prohibition does not apply to coins issued by a State.

Description of Proposal

In general

The proposal would (1) increase the AGI phase-out limits for deductible IRAs, (2) provide that an individual would not be considered an active participant in an IRA merely because the individual's spouse is an active participant, (3) provide an exception from the early withdrawal tax for withdrawals for first-time home purchase (up to $10,000) and long-term unemployed individuals, and (4) replace present-law nondeductible IRAs with a new IRA called the IRA Plus. All individuals could make nondeductible contributions of up to $2,000 annually to an IRA Plus. No income limitations would apply to IRA Plus accounts; however, the $2,000 maximum contribution limit would be reduced to the extent an individual makes deductible contributions to an IRA. An IRA Plus would be an IRA which is designated at the time of establishment as an IRA Plus in the manner prescribed by the Secretary. Qualified distributions from an IRA Plus would not be includible in income.

Increase income phase-out ranges for deductible IRAs

The proposal would increase the AGI phaseout range for deductible IRA contributions as follows:

Taxable years beginning in:	Phase-Out Range Single Taxpayers	Joint Returns
1998 and 1999	$30,000-$40,000	$50,000-$60,000
2000 and 2001	$35,000-$45,000	$60,000-$70,000
2002 and 2003	$40,000-$50,000	$70,000-$80,000
2004 and thereafter	$50,000-$60,000	$80,000-$100,000

Active participant rule

The proposal would provide that an individual is not considered an active participant in an employer-sponsored plan merely because the individual's spouse is an active participant.

Modifications to early withdrawal tax

The proposal would provide that the 10-percent early withdrawal tax does not apply to withdrawals from an IRA (including an IRA Plus) for (1) up to $10,000 of first-time homebuyer expenses and (2) distributions for long-term unemployed individuals.[20]

IRA Plus accounts

Contributions to IRA Plus accounts

The maximum annual contribution that could be made to an IRA Plus would be the lesser of $2,000 (reduced by deductible IRA contributions) or the individual's compensation for the year. As under the present-law rules relating to deductible IRAs, a contribution of up to $2,000 for each spouse could be made to an IRA Plus provided the combined compensation of the spouses is at least equal to the contributed amount.

Contributions to an IRA Plus could be made even after the individual for whom the account is maintained has attained age 70-1/2.

Taxation of distributions

Qualified distributions from an IRA Plus would not be includible in gross income, nor subject to the additional 10-percent tax on early withdrawals. A qualified distribution would be a distribution that (1) is made after the 5-taxable year period beginning with the first taxable year in which the individual made a contribution to an IRA Plus[21], and (2) which is (a) made on or after the date on which the individual attains age 59-1/2, (b) made to a beneficiary (or to the individual's estate) on or after the death of the individual, (c) attributable to the individual's being disabled, or (d) a qualified special purpose distribution. Qualified special purpose distributions would be distributions that are exempt from the 10-percent early withdrawal tax because they are for first-time homebuyer expenses or long-term unemployed individuals.

Distributions from an IRA Plus that are not qualified distributions would be includible in income to the extent attributable to earnings, and subject to the 10-percent early withdrawal tax

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[20] The Chairman's mark would also provide for penalty-free withdrawals from IRAs for education expenses (see below).

[21] As is the case with IRAs generally, contributions to an IRA Plus could be made for a year by the due date for the individual's tax return for the year (determined without regard to extensions). In the case of a contribution to an IRA Plus made after the end of the taxable year, the 5-year holding period would run beginning with the taxable year to which the contribution relates, rather than the year in which the contribution is actually made.

(unless an exception applies). The same exceptions to the early withdrawal tax that apply to IRAs would apply to IRA Plus accounts.

An ordering rule would apply for purposes of determining what portion of a distribution that is not a qualified distribution is includible in income. Under the ordering rule, distributions from an IRA Plus would be treated as made from contributions first, and all an individual's IRA Plus accounts would be treated as a single IRA Plus. Thus, no portion of a distribution from an IRA Plus would be treated as attributable to earnings (and therefore includible in gross income) until the total of all distributions from all the individual's IRA Plus accounts exceeds the amount of contributions.

Distributions from an IRA Plus could be rolled over tax free to another IRA Plus.

Conversions of an IRA to an IRA Plus

All or any part of amounts in a present-law deductible or nondeductible IRA could be converted into an IRA Plus. If the conversion is made before January 1, 1999, the amount that would have been includible in gross income if the individual had withdrawn the converted amounts would be included in gross income ratably over the 4-taxable year period beginning with the taxable year in which the conversion is made. The early withdrawal tax would not apply to such conversions.[22]

A conversion of an IRA into an IRA Plus could be made in a variety of different ways and without taking a distribution. For example, an individual could make a conversion simply by notifying the IRA trustee. Or, an individual could make the conversion in connection with a change in IRA trustees through a rollover or a trustee-to-trustee transfer. If a part of an IRA balance is converted into an IRA Plus, the IRA Plus amounts would have to be held separately.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

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[22] In the case of conversions from an IRA to an IRA Plus, the 5-taxable year holding period would begin with the taxable year in which the conversion was made.

IV. ESTATE, GIFT, AND GENERATION-SKIPPING TAX PROVISIONS

A. Increase in Estate and Gift Tax Unified Credit

Present Law

A gift tax is imposed on lifetime transfers by gift and an estate tax is imposed on transfers at death. Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.[23] A unified credit of $192,800 is provided against the estate and gift tax, which effectively exempts the first $600,000 in cumulative taxable transfers from tax (sec. 2010). For transfers in excess of $600,000, estate and gift tax rates begin at 37 percent and reach 55 percent on cumulative taxable transfers over $3 million (sec. 2001(c)). In addition, a 5-percent surtax is imposed upon cumulative taxable transfers between $10 million and $21,040,000, to phase out the benefits of the graduated rates and the unified credit (sec. 2001(c)(2)).[24]

Description of Proposal

The proposal would increase the present-law unified credit beginning in 1998, from an effective exemption of $600,000 to an effective exemption of $1,000,000 in 2008. The increase in the effective exemption would be phased in according to the following schedule: the effective exemption would be $625,000 for decedents dying and gifts made in 1998; $640,000 in 1999; $660,000 in 2000; $675,000 in 2001; $725,000 in 2002; $750,000 in 2003; $800,000 in 2004; $850,000 in 2005; $900,000 in 2006; $950,000 in 2007; and $1 million in 2008. After 2008, the effective exemption would be indexed annually for inflation. The indexed exemption amount would be rounded to the next lowest multiple of $10,000.

Conforming amendments to reflect the increased unified credit would be made (1) to the 5-percent surtax to conform the phase out of the increased unified credit and graduated rates, (2) to the general filing requirements for an estate tax return under section 6018(a), and (3) to the amount of the unified credit allowed under section 2102(c)(3) with respect to nonresident aliens with U.S. situs property who are residents of certain treaty countries.

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[23] Prior to 1976, separate tax rate schedules applied to the gift tax and the estate tax.

[24] Thus, if a taxpayer has made cumulative taxable transfers equaling $21,040,000 or more, his or her average transfer tax rate is 55 percent. The phaseout has the effect of creating a 60-percent marginal transfer tax rate on transfers in the phaseout range.

Effective Date

The proposal would be effective for decedents dying, and gifts made, after December 31, 1997.

B. Indexing of Certain Other Estate and Gift Tax Provisions

Present Law

Annual exclusion for gifts.--A taxpayer may exclude $10,000 of gifts of present interests in property made by an individual ($20,000 per married couple) to each donee during a calendar year (sec. 2503).

Special use valuation.--An executor may elect for estate tax purposes to value certain qualified real property used in farming or a closely-held trade or business at its current use value, rather than its "highest and best use" value (sec. 2032A). The maximum reduction in value under such an election is $750,000.

Generation-skipping transfer ("GST") tax.--An individual is allowed an exemption from the GST tax of up to $1,000,000 for generation-skipping transfers made during life or at death (sec. 2631).

Installment payment of estate tax.--An executor may elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period (sec. 6166). The tax on the first $1,000,000 in value of a closely-held business is eligible for a special 4-percent interest rate (sec. 6601(j)).

Description of Proposal

The proposal would provide that, after 1998, the $10,000 annual exclusion for gifts, the $750,000 ceiling on special use valuation, the $1,000,000 generation-skipping transfer tax exemption, and the $1,000,000 ceiling on the value of a closely-held business eligible for the special low interest rate (as modified below), would be indexed annually for inflation. Indexing of the annual exclusion would be rounded to the next lowest multiple of $1,000 and indexing of the other amounts would be rounded to the next lowest multiple of $10,000.

Effective Date

The proposal would be effective for decedents dying, and gifts made, after December 31, 1998.

C. Estate Tax Exclusion for Qualified Family-Owned Businesses

Present Law

There are no special estate tax rules for qualified family-owned businesses. All taxpayers are allowed a unified credit in computing the taxpayer's estate and gift tax, which effectively exempts a total of $600,000 in cumulative taxable transfers from the estate and gift tax (sec. 2010). An executor also may elect, under section 2032A, to value certain qualified real property used in farming or another qualifying closely-held trade or business at its current use value, rather than its highest and best use value (up to a maximum reduction of $750,000). In addition, an executor may elect to pay the Federal estate tax attributable to a qualified closely-held business in installments over, at most, a 14-year period (sec. 6166). The tax attributable to the first $1,000,000 in value of a closely-held business is eligible for a special 4-percent interest rate (sec. 6601(j)).

Description of Proposal

The proposal would allow an executor to elect special estate tax treatment for qualified "family-owned business interests" if such interests comprise more than 50 percent of a decedent's estate and certain other requirements are met. In general, the proposal would exclude the first $1 million of value in qualified family-owned business interests from a decedent's estate. This new exclusion for qualified family-owned business interests would be provided in addition to the unified credit.

A qualified family-owned business interest would be defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if one family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns at least 30 percent of the trade or business. An interest in a trade or business would not qualify if any interest in the business (or a related entity) was publicly-traded at any time within three years of the decedent's death. An interest in a trade or business also would not qualify if more than 35 percent of the adjusted ordinary gross income of the business for the year of the decedent's death was personal holding company income (as defined in sec. 543). In the case of a trade or business that owns an interest in another trade or business (i.e., "tiered entities"), special look-through rules would apply. The value of a trade or business qualifying as a family-owned business interest would be reduced to the extent the business holds passive assets or excess cash or marketable securities.

To qualify for the beneficial treatment provided under the proposal, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, each qualified heir (or a member of the qualified heir's family) would be required to materially participate in the trade or business for at least five years of each eight-year period ending within ten years following the decedent's death.

The benefit of the exclusion for qualified family-owned business interests would be subject to recapture if, within 10 years of the decedent's death and before the qualified heir's death, one of the following "recapture events" occurs: (1) the qualified heir ceases to meet the material participation requirements; (2) the qualified heir disposes of any portion of his or her interest in the family-owned business, other than by a disposition to a member of the qualified heir's family or through a qualified conservation contribution; (3) the principal place of business of the trade or business ceases to be located in the United States; or (4) the qualified heir loses U.S. citizenship.

The portion of the reduction in estate taxes that is recaptured would depend upon the number of years that the qualified heir (or members of the qualified heir's family) materially participated in the trade or business between the date of the decedent's death and the date of the recapture event. If the qualified heir (or his or her family members) materially participated in the trade or business after the decedent's death for less than six years, 100 percent of the reduction in estate taxes attributable to that heir's interest would be recaptured; if the participation was for at least six years but less than seven years, 80 percent of the reduction in estate taxes would be recaptured; if the participation was for at least seven years but less than eight years, 60 percent would be recaptured; if the participation was for at least eight years but less than nine years, 40 percent would be recaptured; and if the participation was for at least nine years but less than ten years, 20 percent of the reduction in estates taxes would be recaptured. In general, there would be no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. As under present-law section 2032A, however, the 10-year recapture period could be extended for a period of up to two years if the qualified heir did not begin to use the property for a period of up to two years after the decedent's death.

Effective Date

The proposal would be effective with respect to the estates of decedents dying after December 31, 1997.

D. Reduction in Estate Tax for Certain Land Subject to Permanent Conservation Easement

Present Law

A deduction is allowed for estate and gift tax purposes for a contribution of a qualified real property interest to a charity (or other qualified organization) exclusively for conservation purposes (secs. 2055(f), 2522(d)). For this purpose, a qualified real property interest means the entire interest of the transferor in real property (other than certain mineral interests), a remainder interest in real property, or a perpetual restriction on the use of real property (sec. 170(h)). A "conservation purpose" is (1) preservation of land for outdoor recreation by, or the education of, the general public, (2) preservation of natural habitat, (3) preservation of open space for scenic enjoyment of the general public or pursuant to a governmental conservation policy, and (4) preservation of historically important land or certified historic structures. Also, a contribution will be treated as "exclusively for conservation purposes" only if the conservation purpose is protected in perpetuity.[25]

A donor making a qualified conservation contribution generally is not allowed to retain an interest in minerals which may be extracted or removed by any surface mining method. However, deductions for contributions of conservation interests satisfying all of the above requirements will be permitted if two conditions are satisfied. First, the surface and mineral estates in the property with respect to which the contribution is made must have been separated before June 13, 1976 (and remain so separated) and, second, the probability of surface mining on the property with respect to which a contribution is made must be so remote as to be negligible (sec. 170(h)(5)(B)).

The same definition of qualified conservation contributions also applies for purposes of determining whether such contributions qualify as charitable deductions for income tax purposes.

Description of Proposal

Reduction in estate taxes for certain land subject to permanent conservation easement

The proposal would allow an executor to elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement that meets the following requirements: (1) the land must be located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area; (2) the land must have been owned by the decedent or a member of the decedent's family at all times

[25] A member of the transferor's family includes: (1) his or her ancestors; (2) his or her spouse; (3) a lineal descendant of the decedent, the decedent's spouse or the decedent's parents; and (4) the spouse of any of the foregoing lineal descendants.

during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of section 170(h)) of a qualified real property interest (as generally defined in section 170(h)(2)(C)) had been granted by the transferor or a member of his or her family. For purposes of the proposal, preservation of a historically important land area or a certified historic structure would not qualify as a conservation purpose. To the extent that the value of such land would be excluded from the taxable estate, the basis of such land acquired at death would be a carryover basis (i.e., the basis would not be stepped-up to its fair market value at death). Debt-financed property would not be eligible for the exclusion.

The exclusion amount would be calculated based on the value of the property after the conservation easement has been placed on the property. The exclusion from estate taxes would not extend to the value of any development rights retained by the decedent or donor, although payment for estate taxes on retained development rights could be deferred for up to two years, or until the disposition of the property, whichever is earlier. For this purpose, retained development rights would be any rights retained to use the land for any commercial purpose which is not subordinate to and directly supportive of farming purposes, as defined in section 6420 (e.g., tree farming, ranching, viticulture, and the raising of other agricultural or horticultural commodities).

<u>**Maximum benefit allowed**</u>

The 40-percent estate tax exclusion for land subject to a qualified conservation easement (described above) could be taken only to the extent that the total exclusion for qualified conservation easements, plus the exclusion for qualified family-owned business interests (described in C., above), does not exceed $1 million. The executor of an estate holding land subject to a qualified conservation easement and/or qualified family-owned business interests would be required to designate which of the two benefits is being claimed with respect to each property on which a benefit is claimed.

If the value of the conservation easement is less than 30 percent of (a) the value of the land without the easement, reduced by (b) the value of any retained development rights, then the exclusion percentage would be reduced. The reduction in the exclusion percentage would be equal to two percentage points for each point that the above ratio falls below 30 percent. Thus, for example, if the value of the easement is 25 percent of the value of the land before the easement less the value of the retained development rights, the exclusion percentage would be 30 percent (i.e., the 40 percent amount would be reduced by twice the difference between 30 percent and 25 percent). Under this calculation, if the value of the easement is 5 percent or less of the value of the land before the easement less the value of the retained development rights, the exclusion percentage would be equal to zero.

<u>**Treatment of land subject to a conservation easement for purposes of special-use valuation**</u>

The granting of a qualified conservation easement (as defined above) would not be treated as a disposition triggering the recapture provisions of section 2032A. In addition, the existence of a qualified conservation easement would not prevent such property from subsequently qualifying for special-use valuation treatment under section 2032A.

Retained mineral interests

The proposal also would allow a charitable deduction (for income tax purposes or estate tax purposes) to taxpayers making a contribution of a permanent conservation easement on property where a mineral interest has been retained and surface mining is possible, but its probability is "so remote as to be negligible." Present law provides for a charitable deduction in such a case if the mineral interests have been separated from the land prior to June 13, 1976. The proposal would allow such a charitable deduction to be taken regardless of when the mineral interests had been separated.

Effective Date

The estate tax exclusion would apply to decedents dying after December 31, 1997. The rules with respect to the treatment of conservation easements under section 2032A and with respect to retained mineral interests would be effective for easements granted after December 31, 1997.

E. Installment Payments of Estate Tax Attributable to Closely Held Businesses

Present Law

In general, the Federal estate tax is due within nine months of a decedent's death. Under Code section 6166, an executor generally may elect to pay the estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. If the election is made, the estate may pay only interest for the first four years, followed by up to 10 annual installments of principal and interest. Interest generally is imposed at the rate applicable to underpayments of tax under section 6621 (i.e., the Federal short-term rate plus 3 percentage points). Under section 6601(j), however, a special 4-percent interest rate applies to the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely-held business.

To qualify for the installment payment election, the business must be an active trade or business and the value of the decedent's interest in the closely held business must exceed 35 percent of the decedent's adjusted gross estate. An interest in a closely held business includes: (1) any interest as a proprietor in a business carried on as a proprietorship; (2) any interest in a partnership carrying on a trade or business if the partnership has 15 or fewer partners, or if at least 20 percent of the partnership's assets are included in determining the decedent's gross estate; or (3) stock in a corporation if the corporation has 15 or fewer shareholders, or if at least 20 percent of the value of the voting stock is included in determining the decedent's gross estate.

Description of Proposal

The proposal would extend the period for which Federal estate tax installments could be made under section 6166 to a maximum period of 24 years. If the election were made, the estate would pay only interest for the first four years, followed by up to 20 annual installments of principal and interest.

In addition, the proposal would provide that no interest would be imposed on the amount of deferred estate tax attributable to the first $1,000,000 in taxable value of the closely held business (i.e., the first $1,000,000 in value in excess of the effective exemption provided by the unified credit). Thus, for example, in 1998, when the unified credit is increased to provide an effective exemption of $620,000 (as described above), the amount of estate tax attributable to the value of the closely held business between $620,000 and $1,620,000 would be eligible for the zero-percent interest rate.

The interest rate imposed on the amount of deferred estate tax attributable to the taxable value of the closely held business in excess of $1,000,000 would be reduced to an amount equal to 45 percent of the rate applicable to underpayments of tax. The interest paid on estate taxes deferred under section 6166 would not be deductible for estate or income tax purposes.

Effective Date

The proposal would be effective for decedents dying after December 31, 1997.

F. Estate Tax Recapture from Cash Leases of Specially-Valued Property

Present Law

A Federal estate tax is imposed on the value of property passing at death. Generally, such property is included in the decedent's estate at its fair market value. Under section 2032A, the executor may elect to value certain "qualified real property" used in farming or other qualifying trade or business at its current use value rather than its highest and best use. If, after the special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years (15 years for individuals dying before 1982) of the decedent's death, an additional estate tax is imposed in order to "recapture" the benefit of the special-use valuation (sec. 2032A(c)).

Some courts have held that cash rental of specially-valued property after the death of the decedent is not a qualified use under section 2032A because the heirs no longer bear the financial risk of working the property, and, therefore, results in the imposition of the additional estate tax under section 2032A(c). See Martin v. Commissioner, 783 F.2d 81 (7th Cir. 1986) (cash lease to unrelated party not qualified use); Williamson v. Commissioner, 93 T.C. 242 (1989), aff'd, 974 F.2d 1525 (9th Cir. 1992) (cash lease to family member not a qualified use); Fisher v. Commissioner, 65 T.C.M. 2284 (1993) (cash lease to family member not a qualified use); cf. Minter v. U.S., 19 F.3d 426 (8th Cir. 1994) (cash lease to family's farming corporation is qualified use); Estate of Gavin v. U.S., 1997 U.S. App. Lexis 10383 (8th Cir. 1997) (heir's option to pay cash rent or 50 percent crop share is qualified use).

With respect to a decedent's surviving spouse, a special rule provides that the surviving spouse will not be treated as failing to use the property in a qualified use solely because the spouse rents the property to a member of the spouse's family on a net cash basis. (sec. 2032A(b)(5)). Under section 2032A, members of an individual's family include (1) the individual's spouse, (2) the individual's ancestors, (3) lineal descendants of the individual, of the individual's spouse, or of the individual's parents, and (4) the spouses of any such lineal descendants.

Description of Proposal

The proposal would provide that the cash lease of specially-valued real property by a lineal descendant of the decedent to a member of the lineal descendant's family, who continues to operate the farm or closely held business, does not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under section 2032A(c).

Effective Date

The proposal would be effective for cash rentals occurring after December 31, 1976.

G. Modification of Generation-Skipping Transfer Tax for Transfers to Individuals with Deceased Parents

Present Law

Under the "predeceased parent exception," a direct skip transfer to a transferor's grandchild is not subject to the generation-skipping transfer ("GST") tax if the child of the transferor who was the grandchild's parent is deceased at the time of the transfer (sec. 2612(c)(2)). This "predeceased parent exception" to the GST tax is not applicable to (1) transfers to collateral heirs, e.g., grandnieces or grandnephews, or (2) taxable terminations or taxable distributions.

Description of Proposal

The proposal would extend the predeceased parent exception to transfers to collateral heirs, provided that the decedent has no living lineal descendants at the time of the transfer. In addition, the proposal would extend the predeceased parent exception (as modified by the preceding sentence) to certain taxable terminations and taxable distributions.

Effective Date

The proposal would be effective for generation-skipping transfers occurring after December 31, 1997.

V. EXTENSION OF CERTAIN EXPIRING TAX PROVISIONS

A. Research Tax Credit

Present Law

General rule

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and generally will not apply to amounts paid or incurred after May 31, 1997.[26]

A 20-percent research tax credit also applied to the excess of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the "university basic research credit" (see sec. 41(e)).

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.[27]

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[26] When originally enacted, the research tax credit applied to qualified expenses incurred after June 30, 1981. The credit was modified several times and was extended through June 30, 1995. The credit later was extended for the period July 1, 1996, through May 31, 1997 (with a special 11-month extension for taxpayers that elect to be subject to the alternative incremental research credit regime).

[27] The Small Business Job Protection Act of 1996 expanded the definition of "start-up firms" under section 41(c)(3)(B)(I) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983.

In computing the credit, a taxpayer's base amount may not be less than 50 percent of its current-year qualified research expenditures.

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, research expenditures and gross receipts of the taxpayer are aggregated with research expenditures and gross receipts of certain related persons for purposes of computing any allowable credit (sec. 41(f)(1)). Special rules apply for computing the credit when a major portion of a business changes hands, under which qualified research expenditures and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage (sec. 41(f)(3)).

__Alternative incremental research credit regime__

As part of the Small Business Job Protection Act of 1996, taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1 percent (i.e., the base amount equals 1 percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 2.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of 2 percent. A credit rate of 2.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2 percent. An election to be subject to this alternative incremental credit regime may be made only for a taxpayer's first taxable year beginning after June 30, 1996, and before July 1, 1997, and such an election applies to that taxable year and all subsequent years (in the event that the credit subsequently is extended by Congress) unless revoked with the consent of

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A special rule (enacted in 1993) is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm will be assigned a fixed-base percentage of 3 percent for each of its first five taxable years after 1993 in which it incurs qualified research expenditures. In the event that the research credit is extended beyond the scheduled expiration date, a start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenditures will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage will be its actual ratio of qualified research expenditures to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

the Secretary of the Treasury. If a taxpayer elects the alternative incremental research credit regime for its first taxable year beginning after June 30, 1996, and before July 1, 1997, then all qualified research expenses paid or incurred during the first 11 months of such taxable year are treated as qualified research expenses for purposes of computing the taxpayer's credit.

Eligible expenditures

Qualified research expenditures eligible for the research tax credit consist of: (1) "in-house" expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called "contract research expenses").[28]

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 (described below) but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors (sec. 41(d)(3)). In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys, market research or development, or routine quality control (sec. 41(d)(4)).

Expenditures attributable to research that is conducted outside the United States do not enter into the credit computation. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

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[28] Under a special rule enacted as part of the Small Business Job Protection Act of 1996, 75 percent of amounts paid to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

Relation to deduction

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized. However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year. Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

Description of Proposal

The research tax credit would be extended for 31 months--i.e., generally for the period June 1, 1997, through December 31, 1999.

Under the proposal, taxpayers would be permitted to elect the alternative incremental research credit regime under section 41(c)(4) for any taxable year beginning after June 30, 1996, and such election would apply to that taxable year and all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury.

Effective Date

The proposal generally would be effective for qualified research expenditures paid or incurred during the period June 1, 1997, through December 31, 1999.

A special rule would provide that, notwithstanding the general termination date for the research credit of December 31, 1999, if a taxpayer elects to be subject to the alternative incremental research credit regime for its first taxable year beginning after June 30, 1996, and before July 1, 1997, the alternative incremental research credit would be available during the entire 42-month period beginning with the first month of such taxable year--i.e., the equivalent of the 11-month extension provided for by the Small Business Job Protection Act of 1996 plus an additional 31-month extension provided for by this legislation. However, to prevent taxpayers from effectively obtaining more than 42-months of research credits from the Small Business Job Protection Act of 1996 and this legislation, the 42-month period for taxpayers electing the alternative incremental research credit regime would be reduced by the number of months (if any) after June 1996 with respect to which the taxpayer claimed research credit amounts under the regular, 20-percent research credit rules.

B. Contributions of Stock to Private Foundations

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization.[29] However, in the case of a charitable contribution of short-term gain, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.[30]

In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property. However, under a special rule contained in section 170(e)(5), taxpayers are allowed a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation prior to May 31, 1997.[31] Qualified appreciated stock is defined as publicly traded stock which is capital gain property. The fair-market-value deduction for qualified appreciated stock donations applies only to the extent that total donations made by the donor to private foundations of stock in a particular corporation did not exceed 10 percent of the outstanding stock of that corporation. For this purpose, an individual is treated as making all contributions that were made by any member of the individual's family.

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[29] The amount of the deduction allowable for a taxable year with respect to a charitable contribution may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)).

[30] As part of the Omnibus Budget Reconciliation Act of 1993, Congress eliminated the treatment of contributions of appreciated property (real, personal, and intangible) as a tax preference for alternative minimum tax (AMT) purposes. Thus, if a taxpayer makes a gift to charity of property (other than short-term gain, inventory, or other ordinary income property, or gifts to private foundations) that is real property, intangible property, or tangible personal property the use of which is related to the donee's tax-exempt purpose, the taxpayer is allowed to claim the same fair-market-value deduction for both regular tax and AMT purposes (subject to present-law percentage limitations).

[31] The special rule contained in section 170(e)(5), which was originally enacted in 1984, expired January 1, 1995. The Small Business Job Protection Act of 1996 reinstated the rule for 11 months--for contributions of qualified appreciated stock made to private foundations during the period July 1, 1996, through May 31, 1997.

Description of Proposal

The proposal would extend the special rule contained in section 170(e)(5) for contributions of qualified appreciated stock made to private foundations during the period June 1, 1997, through December 31, 1999.

Effective Date

The proposal would be effective for contributions of qualified appreciated stock to private foundations made during the period June 1, 1997, through December 31, 1999.

C. Work Opportunity Tax Credit

Present Law

In general

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of seven targeted groups. The credit generally is equal to 35 percent of qualified wages. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer. For a vocational rehabilitation referral, however, the period will begin on the day the individual begins work for the employer on or after the beginning of the individual's vocational rehabilitation plan as under prior law.

Generally, no more than $6,000 of wages during the first year of employment is permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual is $2,100. With respect to qualified summer youth employees, the maximum credit is 35 percent of up to $3,000 of qualified first-year wages, for a maximum credit of $1,050.

The deduction for wages is reduced by the amount of the credit.

Targeted groups eligible for the credit

(1) Families receiving AFDC

An eligible recipient is an individual certified by the designated local employment agency as being a member of a family eligible to receive benefits under AFDC or its successor program for a period of at least nine months part of which is during the 9-month period ending on the hiring date. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for the AFDC or its successor program.

(2) Qualified ex-felon

A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under any State or Federal law, (2) being a member of a family that had an income during the six months before the earlier of the date of determination or the hiring date which on an annual basis is 70 percent or less of the Bureau of Labor Statistics lower living standard, and (3) having a hiring date within one year of release from prison or date of conviction.

(3) High-risk-youth

A high-risk youth is an individual certified as being at least 18 but not yet 25 on the hiring date and as having a principal place of abode within an empowerment zone or enterprise community (as defined under Subchapter U of the Internal Revenue Code). Qualified wages will not include wages paid or incurred for services performed after the individual moves outside an empowerment zone or enterprise community.

(4) Vocational rehabilitation referral

Vocational rehabilitation referrals are those individuals who have a physical or mental disability that constitutes a substantial handicap to employment and who have been referred to the employer while receiving, or after completing, vocational rehabilitation services under an individualized, written rehabilitation plan under a State plan approved under the Rehabilitation Act of 1973 or under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code. Certification will be provided by the designated local employment agency upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

(5) Qualified summer youth employee

Qualified summer youth employees are individuals: (1) who perform services during any 90-day period between May 1 and September 15, (2) who are certified by the designated local agency as being 16 or 17 years of age on the hiring date, (3) who have not been an employee of that employer before, and (4) who are certified by the designated local agency as having a principal place of abode within an empowerment zone or enterprise community (as defined under Subchapter U of the Internal Revenue Code). As with high-risk youths, no credit is available on wages paid or incurred for service performed after the qualified summer youth moves outside of an empowerment zone or enterprise community. If, after the end of the 90-day period, the employer continues to employ a youth who was certified during the 90-day period as a member of another targeted group, the limit on qualified first-year wages will take into account wages paid to the youth while a qualified summer youth employee.

(6) Qualified veteran

A qualified veteran is a veteran who is a member of a family certified as receiving assistance under: (1) AFDC for a period of at least nine months part of which is during the 12-month period ending on the hiring date, or (2) a food stamp program under the Food Stamp Act of 1977 for a period of at least three months part of which is during the 12-month period ending on the hiring date. For these purposes, members of a family are defined to include only those individuals taken into account for purposes of determining eligibility for: (I) the AFDC or its successor program, and (ii) a food stamp program under the Food Stamp Act of 1977, respectively.

Further, a qualified veteran is an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not an eligible employee if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

(7) Families receiving food stamps

An eligible recipient is an individual aged 18 but not yet 25 certified by a designated local employment agency as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least six months ending on the hiring date. In the case of families that cease to be eligible for food stamps under section 6(o) of the Food Stamp Act of 1977, the six-month requirement is replaced with a requirement that the family has been receiving food stamps for at least three of the five months ending on the date of hire. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

Minimum employment period

No credit is allowed for wages paid unless the eligible individual is employed by the employer for at least 180 days (20 days in the case of a qualified summer youth employee) or 400 hours (120 hours in the case of a qualified summer youth employee).

Expiration date

The credit is effective for wages paid or incurred to a qualified individual who begins work for an employer after September 30, 1996, and before October 1, 1997.

Description of Proposal

The proposal would extend for 27 months the work opportunity tax credit. The proposal would also modify the eligibility definition for the AFDC families targeted group. Specifically, under the proposal an otherwise eligible member of a family receiving AFDC benefits for any 9-month period (whether or not consecutive) during the 18-month period ending on the hiring date would qualify as a member of this targeted group (this expansion applies whether or not the individual is a qualified veteran). Finally, the proposal would add another targeted group to the credit. The new targeted group would be persons certified by the designated local agency as receiving certain Supplemental Security Income (SSI) benefits for any month ending within the 60 day period ending on the hiring date. For these purposes, SSI benefits would mean benefits under title XVI of the Social Security Act (including supplemental security income benefits of the type described in section 1616 of such Act or section 212 of Public Law 93-66).

Effective Date

The proposals to extend and modify the work opportunity tax credit would be effective for wages paid or incurred to qualified individuals who begin work for the employer after September 30, 1997, and before January 1, 2000.

D. Orphan Drug Tax Credit

Present Law

A 50-percent nonrefundable tax credit is allowed for qualified clinical testing expenses incurred in testing of certain drugs for rare diseases or conditions, generally referred to as "orphan drugs." Qualified testing expenses are costs incurred to test an orphan drug after the drug has been approved for human testing by the Food and Drug Administration ("FDA") but before the drug has been approved for sale by the FDA. A rare disease or condition is defined as one that (1) affects less than 200,000 persons in the United States, or (2) affects more than 200,000 persons, but for which there is no reasonable expectation that businesses could recoup the costs of developing a drug for such disease or condition from U.S. sales of the drug. These rare diseases and conditions include Huntington's disease, myoclonus, ALS (Lou Gehrig's disease), Tourette's syndrome, and Duchenne's dystrophy (a form of muscular dystrophy).

As with other general business credits (sec. 38), taxpayers are allowed to carry back unused credits to three years preceding the year the credit is earned (but not to a taxable year ending before July 1, 1996) and to carry forward unused credits to 15 years following the year the credit is earned. The credit cannot be used to offset a taxpayer's alternative minimum tax liability.

The orphan drug tax credit expired and does not apply to expenses paid or incurred after May 31, 1997.[32]

Description of Proposal

The orphan drug tax credit would be permanently extended.

Effective Date

The proposal would be effective for qualified clinical testing expenses paid or incurred after May 31, 1997.

[32] The orphan drug tax credit originally was enacted in 1983 and was extended on several occasions. The credit expired on December 31, 1994, and later was reinstated for the period July 1, 1996, through May 31, 1997.

VI. DISTRICT OF COLUMBIA TAX INCENTIVES

Present Law

Empowerment zones and enterprise communities

In general

Pursuant to the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), the Secretaries of the Department of Housing and Urban Development (HUD) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994. As required by law, six empowerment zones are located in urban areas (with aggregate population for the six designated urban empowerment zones limited to 750,000) and three empowerment zones are located in rural areas.[33] Of the enterprise communities, 65 are located in urban areas and 30 are located in rural areas (sec. 1391). Designated empowerment zones and enterprise communities were required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations (sec. 1392). Portions of the District of Columbia were designated as an enterprise community.

The following tax incentives are available for certain businesses located in empowerment zones: (1) an annual 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the zone; (2) an additional $20,000 of expensing under Code section 179 for "qualified zone property" placed in service by an "enterprise zone business" (accordingly, certain businesses operating in empowerment zones are allowed up to $38,000 of expensing for 1997; the allowable amount will increase to $38,500 for 1998); and (3) special tax-exempt financing for certain zone facilities (described in more detail below).

The 95 enterprise communities are eligible for the special tax-exempt financing benefits but not the other tax incentives available in the nine empowerment zones. In addition to these tax incentives, OBRA 1993 provided that Federal grants would be made to designated empowerment zones and enterprise communities.

The tax incentives for empowerment zones and enterprise communities generally will be available during the period that the designation remains in effect, i.e., a 10-year period.

Definition of "qualified zone property"

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[33] The six designated urban empowerment zones are located in New York City, Chicago, Atlanta, Detroit, Baltimore, and Philadelphia-Camden (New Jersey). The three designated rural empowerment zones are located in Kentucky Highlands (Clinton, Jackson, and Wayne counties, Kentucky), Mid-Delta Mississippi (Bolivar, Holmes, Humphreys, Leflore counties, Mississippi), and Rio Grande Valley Texas (Cameron, Hidalgo, Starr, and Willacy counties, Texas).

Present-law section 1397C defines "qualified zone property" as depreciable tangible property (including buildings), provided that: (1) the property is acquired by the taxpayer (from an unrelated party) after the zone or community designation took effect; (2) the original use of the property in the zone or community commences with the taxpayer; and (3) substantially all of the use of the property is in the zone or community in the active conduct of a trade or business by the taxpayer in the zone or community. In the case of property which is substantially renovated by the taxpayer, however, the property need not be acquired by the taxpayer after zone or community designation or originally used by the taxpayer within the zone or community if, during any 24-month period after zone or community designation, the additions to the taxpayer's basis in the property exceed the greater of 100 percent of the taxpayer's basis in the property at the beginning of the period, or $5,000.

Definition of "enterprise zone business"

Present-law section 1397B defines the term "enterprise zone business" as a corporation or partnership (or proprietorship) if for the taxable year: (1) the sole trade or business of the corporation or partnership is the active conduct of a qualified business within an empowerment zone or enterprise community; (2) at least 80 percent of the total gross income is derived from the active conduct of a "qualified business" within a zone or community; (3) substantially all of the business's tangible property is used within a zone or community; (4) substantially all of the business's intangible property is used in, and exclusively related to, the active conduct of such business; (5) substantially all of the services performed by employees are performed within a zone or community; (6) at least 35 percent of the employees are residents of the zone or community; and (7) no more than five percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business.

A "qualified business" is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license.[34] In addition, the leasing of real property that is located within the empowerment zone or community to others is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property to others is not a qualified business unless substantially all of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone or enterprise community.

Tax-exempt financing rules

[34] Also, a qualified business does not include certain facilities described in section 144(c)(6)(B) (e.g., massage parlor, hot tub facility, or liquor store) or certain large farms.

Tax-exempt private activity bonds may be issued to finance certain facilities in empowerment zones and enterprise communities. These bonds, along with most private activity bonds, are subject to an annual private activity bond State volume cap equal to $50 per resident of each State, or (if greater) $150 million per State.

Qualified enterprise zone facility bonds are bonds 95 percent or more of the net proceeds of which are used to finance (1) "qualified zone property" (as defined above) the principal user of which is an "enterprise zone business" (also defined above[35]), or (2) functionally related and subordinate land located in the empowerment zone or enterprise community. These bonds may only be issued while an empowerment zone or enterprise community designation is in effect.

The aggregate face amount of all qualified enterprise zone bonds for each qualified enterprise zone business may not exceed $3 million per zone or community. In addition, total qualified enterprise zone bond financing for each principal user of these bonds may not exceed $20 million for all zones and communities.

Taxation of capital gains

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of capital assets, the net capital gain generally is taxed at the same rate as ordinary income, except that the maximum rate of tax is limited to 28 percent of the net capital gain.[36] Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, and (5) certain publications of the Federal Government.

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[35] For purposes of the tax-exempt financing rules, an "enterprise zone business" also includes a business located in a zone or community which would qualify as an enterprise zone business if it were separately incorporated.

[36] The Revenue Reconciliation Act of 1993 added Code section 1202, which provides a 50-percent exclusion for gain from the sale of certain small business stock acquired at original issue and held for at least five years.

In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property generally is not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method.

Description of Proposal

The following tax incentives would take effect only if, prior to January 1, 1998, a Federal law is enacted creating a District of Columbia economic development corporation that is an instrumentality of the District of Columbia government.[37]

Designation of D.C. Enterprise Zone

Certain economically depressed census tracts within the District of Columbia would be designated as the "D.C. Enterprise Zone," within which businesses are eligible for special tax incentives. The census tracts that compose the D.C. Enterprise Zone would be (1) all census tracts that presently are part of the D.C. enterprise community designated under section 1391 (i.e., portions of Anacostia, Mt. Pleasant, Chinatown, and the easternmost part of the District) and (2) all additional census tracts within the District of Columbia where the poverty rate is at least 35 percent. The D.C. Enterprise Zone designation generally would remain in effect for five years--i.e., for the period from January 1, 1998, through December 31, 2002.[38]

Tax incentives for D.C. Enterprise Zone

The following tax incentives that are available under present law to certain businesses in empowerment zones would be available in the D.C. Enterprise Zone (modified as described below): (1) a 20-percent wage credit for the first $15,000 of wages paid to D.C. Enterprise Zone residents who work in the D.C. Enterprise Zone; (2) an additional $20,000 of expensing under Code section 179 for qualified zone property; and (3) special tax-exempt financing for certain zone facilities.

In general, the wage credit for certain D.C. Enterprise Zone residents who work in the D.C. Enterprise Zone would be the same as is available in empowerment zones under present

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[37] In addition, the proposal would assume the enactment of certain modifications to Federal law (other than Federal tax laws contained in the Internal Revenue Code) similar to those proposed by the Administration that would clarify and expand the District's authority to issue revenue bonds.

[38] The status of certain census tracts within the District as an enterprise community designated under section 1391 also would terminate on December 31, 2002.

law. However, the wage credit rate would remain at 20 percent for the D.C. Enterprise Zone for the period 1998 through 2002 (and would not phase down to 15 percent in the year 2002 as under present-law section 1396). The wage credit would be effective for wages paid (or incurred) to a qualified individual after December 31, 1997, and before January 1, 2003.

The increased expensing under Code section 179 would be effective for property placed in service in taxable years beginning after December 31, 1997, and before January 1, 2003. Thus, qualified D.C. Enterprise Zone property (defined as under present law section 1397C) placed in service in taxable years beginning in 1998 would be eligible for up to $38,500 of expensing.

A qualified D.C. Zone business (defined as under present law section 1394(b)(3)) would be permitted to borrow proceeds from the issuance of qualified enterprise zone facility bonds. Such bonds could be issued only by a newly created economic development corporation and would be subject to the requirements applicable under present law to enterprise zone facility bonds, except that the amount of outstanding bond proceeds that can be borrowed by any qualified District business could not exceed $15 million (rather than $3 million). The special tax-exempt bond provisions would apply to bonds issued after December 31, 1997, and prior to January 1, 2003.

Tax incentives for entire District of Columbia

Tax credits for equity investments in and loans to businesses located in the District of Columbia

A newly created economic development corporation would be authorized to allocate $75 million in tax credits to taxpayers that make certain equity investments in, or loans to, businesses (either corporations or partnerships) engaged in an active trade or business in the District of Columbia. The business need not be located in the D.C. Enterprise Zone, although factors to be considered in the allocation of credits would include whether the project would provide job opportunities for low and moderate income residents of the D.C. Enterprise Zone and whether the business is located in the D.C. Enterprise Zone. Eligible businesses would not be required to satisfy the criteria of a qualified D.C. Zone business, described above. Such credits would be nonrefundable and could be used to offset a taxpayer's alternative minimum tax (AMT) liability.

Under the proposal, the amount of credit could not exceed 25 percent of the amount invested (or loaned) by the taxpayer. Thus, the economic development corporation would be permitted to allocate the full $75 million in tax credits to no less than $300 million in equity investments in, or loans, to eligible businesses.

Under the proposal, credits could be allocated to loans made to an eligible business only if the business uses the loan proceeds to purchase depreciable tangible property and any functionally related and subordinate land. Credits could be allocated to equity investments only if the equity interest was acquired for cash. Any credits allocated to a taxpayer making an equity investment would be subject to recapture if the equity interest is disposed of by the taxpayer within five years. A taxpayer's basis in an equity investment would be reduced by the amount of the credit.

The proposal would apply to credit amounts allocated for taxable years beginning after December 31, 1997, and before January 1, 2003.[39]

Zero-percent capital gains rate

The proposal would provide a zero-percent capital gains rate for capital gains from the sale of certain qualified D.C. assets held for more than five years. In general, qualified D.C. assets would mean stock or partnership interests held in, or tangible property held by, a qualified D.C. business.

Qualified D.C. business

A "qualified D.C. business" generally would be required to satisfy the requirements of an "enterprise zone business" under present law, applied as if the District (in its entirety) were an empowerment zone. Thus, a corporation or partnership would be a qualified D.C. business if (1) its sole trade or business is the active conduct of a "qualified business" within the District; (2) at least 80 percent of the total gross income is derived from the active conduct of a "qualified business" within the District; (3) substantially all of the business's tangible property is used within the District; (4) substantially all of the business's intangible property is used in, and exclusively related to, the active conduct of such business; (5) substantially all of the services performed by employees are performed within the District; and (6) no more than five percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business.[40] A "qualified business" would mean any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license.[41] In addition, the leasing of real property that is located within the District to others would be treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from qualified D.C. businesses. The rental of tangible personal

[39] As a general business credit, the credit could be carried back three years (but not before January 1, 1998) and forward for fifteen years.

[40] The requirement under present-law section 1397B(b)(6) that at least 35 percent of the employees of the business be zone residents would not apply when determining whether an entity is a qualified D.C. business.

[41] Also, as under present law, a qualified business would not include certain facilities described in section 144(c)(6)(B) (e.g., massage parlor, hot tub facility, or liquor store) or certain large farms.

property to others would not be a qualified business unless substantially all of the rental of such property is by qualified D.C. businesses or by residents of the District.

Qualified D.C. assets

For purposes of the proposal, "qualified D.C. assets" would include (1) D.C. business stock, (2) D.C. partnership interests, and (3) D.C. business property.

"D.C. business stock" would mean stock in a domestic corporation originally issued after December 31, 1997, that, at the time of issuance[42] and during substantially all of the taxpayer's holding period, was a qualified D.C. business, provided that such stock was acquired by the taxpayer on original issue from the corporation solely in exchange for cash before January 1, 2003.[43] A "D.C. partnership interest" would mean a domestic partnership interest originally issued after December 31, 1997, that is acquired by the taxpayer from the partnership solely in exchange for cash before January 1, 2003, provided that, at the time such interest was acquired[44] and during substantially all of the taxpayer's holding period, the partnership was a qualified D.C. business. Finally, "D.C. business property" would mean tangible property acquired by the taxpayer by purchase (within the meaning of present law section 179(d)(2)) after December 31, 1997, and before January 1, 2003, provided that the original use of such property in the District commences with the taxpayer and substantially all of the use of such property during substantially all of the taxpayer's holding period was in a qualified D.C. business of the taxpayer.

A special rule would provide that, in the case of business property that is "substantially renovated," such property need not be acquired by the taxpayer after December 31, 1997, nor need the original use of such property in the District commence with the taxpayer. For these purposes, property would be treated as "substantially renovated" if, prior to January 1, 2003, additions to basis with respect to such property in the hands of the taxpayer during any 24-month period beginning after December 31, 1997, exceed the greater of (1) an amount equal to the adjusted basis at the beginning of such 24-month period in the hands of the taxpayer, or (2) $5,000. Thus, substantially renovated real estate located in the District could constitute D.C. business property. However, the proposal specifically would exclude land that is not an integral part of a D.C. business from the definition of D.C. business property.

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[42] In the case of a new corporation, it would be sufficient if the corporation is being organized for purposes of being a qualified D.C. business.

[43] Qualified D.C. business stock would not include any stock acquired from a corporation which made a substantial stock redemption or distribution (without a bona fide business purpose therefore) in an attempt to avoid the purposes of the provision. A similar rule would apply with respect to qualified D.C. partnership interests.

[44] In the case of a new partnership, it would be sufficient if the partnership is being formed for purposes of being a D.C. business.

In addition, qualified D.C. assets would include property that was a qualified D.C. asset in the hands of a prior owner, provided that at the time of acquisition, and during substantially all of the subsequent purchaser's holding period, either (1) substantially all of the use of the property is in a qualified D.C. business, or (2) the property is an ownership interest in a qualified D.C. business.

In general, gain eligible for the zero-percent tax rate would mean gain from the sale or exchange of a qualified D.C. asset that is (1) a capital asset or (2) property used in the trade or business as defined in section 1231(b). Gain attributable to periods before December 31, 1997, would not be qualified capital gain. No gain attributable to real property, or an intangible asset, which is not an integral part of a D.C. business would qualify for the zero-percent rate.

The proposal would provide that property that ceases to be a qualified D.C. asset because the property is no longer used in (or no longer represents an ownership interest in) a qualified D.C. business after the five-year period beginning on the date the taxpayer acquired such property would continue to be treated as a qualified D.C. asset. Under this rule, the amount of gain eligible for the zero-percent capital gains rate could not exceed the amount which would be qualified capital gain had the property been sold on the date of such cessation.

Special rules would be provided for pass-through entities (i.e., partnerships, S corporations, regulated investment companies, and common trust funds). In the case of a sale or exchange of an interest in a pass-through entity that was not a qualified D.C. business during substantially all of the period that the taxpayer held the interest, the zero-percent capital gains rate would apply to the extent that the gain is attributable to amounts that would have been qualified capital gain had the underlying assets been sold for their fair market value on the date of the sale or exchange of the interest in the pass-through entity. This rule would apply only if the interest in the pass-through entity were held by the taxpayer for more than five years. In addition, the rule would apply only to qualified D.C. assets that were held by the pass-through entity for more than five years, and throughout the period that the taxpayer held the interest in the pass-through entity.

The proposal also would provide that in the case of a transfer of a qualified D.C. asset by gift, at death, or from a partnership to a partner that held an interest in the partnership at the time that the qualified D.C. asset was acquired, (1) the transferee is to be treated as having acquired the asset in the same manner as the transferor, and (2) the transferee's holding period includes that of the transferor. In addition, rules similar to those contained in section 1202(I)(2) regarding treatment of contributions to capital after the original issuance date and section 1202(j) regarding treatment of certain short positions apply.

Effective Date

The D.C. tax incentives generally would be effective January 1, 1998, and would remain in effect for five years until the termination of the D.C. Enterprise Zone designation on December 31, 2002. However, the zero-percent tax rate for capital gains would be effective for qualified D.C. assets purchased (or substantially renovated) during the period January 1, 1998, through December 31, 2002, for any gain accruing with respect to such assets after the date or purchase (or substantial renovation).

VII. MISCELLANEOUS PROVISIONS

1. Create Intercity Passenger Rail Fund

Present Law

Separate Federal excise taxes are imposed on specified transportation motor fuels. Taxable fuels include gasoline, diesel fuel, and special motor fuels used for highway transportation, gasoline and diesel fuel used in motorboats, diesel fuel used in trains, fuels used in inland waterway transportation, and aviation fuel (gasoline and jet fuel). Motor fuels used by all of these transportation sectors are subject to a permanent 4.3-cents-per-gallon excise tax, enacted by the Omnibus Budget Reconciliation Act of 1993. Revenues from the 4.3-cents-per-gallon excise tax are retained in the General Fund of the Treasury.

The aggregate tax rate varies for each transportation sector. For example, diesel fuel used in trains is subject to an aggregate General Fund tax rate of 5.55 cents per gallon. Transportation sectors that benefit from Federal public works and environmental programs also are subject to additional tax rates (beyond the 4.3-cents-per-gallon General Fund rate) to finance Federal Trust Funds established as a financing source for those programs. All motor fuels excise taxes other than the 4.3-cents-per-gallon General Fund excise tax are temporary (i.e., have scheduled expiration dates). Table 1, below, shows the tax rates applicable to various transportation sectors, by Trust Fund and General Fund component.

Table 1. Present-Law Federal Motor Fuels Excise Tax Rates on Various Transportation Sectors

(rates shown in cents per gallon)

Transportation Sector	Trust Fund	General Fund	Total Tax
Highway Transportation			
In general (trucks, automobiles)			
Gasoline	14.0	4.3	18.3
Diesel fuel	20.0	4.3	24.3
Special motor fuels	14.0	4.3	18.3
Private intercity bus			
Gasoline	no tax	no tax	no tax
Diesel fuel	3.0	4.3	7.3
Rail Transportation	no tax	5.55	5.55

Water Transportation			
Inland waterway	20.0	4.3	24.3
Recreational boats			
Gasoline	14.0	4.3	18.3
Diesel fuel	no tax	no tax[45]	no tax
Air Transportation			
Commercial aviation	no tax	4.3	4.3
Noncommercial aviation			
Gasoline	15.0	4.3	19.3
Jet fuel	17.5	4.3	21.8

Description of Proposal

Intercity Rail Fund provisions

The proposal would establish an Intercity Passenger Rail Fund (the "Rail Fund") in the Internal Revenue Code. The Rail Fund would be financed with amounts equivalent to 0.5 cent per gallon of the excise taxes imposed on all gasoline, diesel fuel, special motor fuels, inland waterway fuels, and aviation fuels after September 30, 1997, and before April 16, 2001.

Amounts deposited in the Rail Fund would be divided between Amtrak and States not receiving Amtrak passenger rail service to finance obligations incurred after September 30, 1997, and before April 16, 2001. Although transfers to the Rail Fund and authority to enter into new obligations would terminate after April 15, 2001, monies deposited in the Fund and obligated before April 16, 2001, would remain available after that date to satisfy outstanding obligations.

Each State not receiving Amtrak rail service would receive an allocation each fiscal year not exceeding one percent of the lesser of (1) Rail Fund revenues for the year or (2) the aggregate amount appropriated from the Rail Fund for the year. Allocations to these non-Amtrak States would be pro-rated on a monthly basis if Amtrak service was provided in the State during a portion of a fiscal year. Non-Amtrak States could use the amounts they received for capital improvements and maintenance expenditures related to intercity passenger rail and bus service provided within their respective jurisdictions and certified by the Department of

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[45] A General Fund tax rate of 24.3 cents per gallon, enacted in 1993 to be effective through December 31, 1999, was suspended through December 31, 1997, by the Small Business Job Protection Tax Act of 1996. Another proposal in the Chairman's Mark would repeal this tax on diesel fuel used in recreational motorboats.

Transportation as eligible. The balance of the Rail Fund revenues would be available to Amtrak for financing capital improvements, including equipment, rolling stock, and maintenance facilities, as well as for maintenance of existing equipment.

Section 207 of the conference report on the FY 1998 Budget Resolution (H. Con. Res. 84) established a reserve fund to accommodate transfer of these excise tax revenues to the Rail Fund and their subsequent expenditure from the Fund in transportation appropriations Acts.

Tax treatment of Rail Fund expenditures

Amounts received from the Rail Fund by Amtrak and other taxable entities would not be included in gross income when received. However, the basis of any property financed with the monies would be reduced by the tax-free amounts received, and no deduction would be allowed for any expenditures attributable to those amounts.

Effective Date

The proposal would be effective on October 1, 1997.

2. Provide above-the-line deduction for certain business expenses

Present Law

Under present law, individuals may generally deduct ordinary and necessary business expenses in determining adjusted gross income ("AGI"). This deduction does not apply in the case of an individual performing services as an employee. Employee business expenses are generally deductible only as a miscellaneous itemized deduction, i.e., only to the extent all the taxpayer's miscellaneous itemized deductions exceed 2 percent of the taxpayer's AGI. Employee business expenses are not allowed as a deduction for alternative minimum tax purposes.

Description of Proposal

Under the proposal, employee business expenses relating to service as an official of a State or local government (or political subdivision thereof) would be deductible in computing AGI ("above the line"), provided the elected official is compensated in whole or in part on a fee basis. Consequently, such expenses would also be deductible for minimum tax purposes.

Effective Date

The proposal would apply to expenses paid or incurred in taxable years beginning after December 31, 1997.

3. Repeal application of UBIT to ESOPs of S corporations

Present Law

Under present law, for taxable years beginning after December 31, 1997, certain tax-exempt organizations, including employee stock ownership plans ("ESOPs") can be a shareholder of an S corporation. Items of income or loss of the S corporation will flow through to qualified tax-exempt shareholders as unrelated business taxable income, regardless of the source of the income.

Description of Proposal

The proposal would repeal the provision treating items of income or loss of an S corporation as unrelated business taxable income in the case of an employee stock ownership plan that is an S corporation shareholder.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1997.

4. Treatment of multiemployer plans under section 415

Present Law

Present law imposes limits on contributions and benefits under qualified plans based on the type of plan. In the case of defined benefit pension plans, the limit on the annual retirement benefit is the lesser of (1) 100 percent of compensation or (2) $125,000 (indexed for inflation).

Description of Proposal

The proposal would eliminate the application of the 100 percent of compensation limitation for multiemployer defined benefit pension plans. Such plans would only be subject to the dollar limitation.

Effective Date

The proposal would be effective for years beginning after December 31, 1997.

5. Modification of partial termination rules

Present Law

Under the Internal Revenue Code, pension plan benefits are required to become fully vested upon termination or partial termination of the plan. The plan document is required to contain a provision reflecting this rule. Under section 552 of the Deficit Reduction Act of 1984 ("DEFRA"), for purposes of this rule, a partial termination is treated as not occurring if (1) the partial termination is a result of a decline in plan participation which occurs by reason of the completion of the Trans-Alaska Oil Pipeline construction project and occurred after December 31, 1975, and before January 1, 1980, with respect to participants employed in Alaska; (2) no discrimination occurred with respect to the partial termination; and (3) it is established to the satisfaction of the Secretary of the Treasury that the benefits of the provision will not accrue to the employers under the plan.

Description of Proposal

The proposal would clarify that section 552 of DEFRA applies for the Code, any other provision of law, and any plan or trust provision.

Effective Date

The proposal would be effective as if included in section 552 of DEFRA.

6. Clarify tax-exempt status of certain State workmen's compensation funds

Present Law

In general, the Internal Revenue Service ("IRS") takes the position that organizations that provide insurance for their members or other individuals are not considered to be engaged in a tax-exempt activity. The IRS maintains that such insurance activity is either (1) a regular business of a kind ordinarily carried on for profit, or (2) an economy or convenience in the conduct of members' businesses because it relieves the members from obtaining insurance on an individual basis.

Certain insurance risk pools have qualified for tax exemption under Code section 501(c)(6). In general, these organizations (1) assign any insurance policies and administrative functions to their member organizations (although they may reimburse their members for amounts paid and expenses); (2) serve an important common business interest of their members; and (3) must be membership organizations financed, at least in part, by membership dues.

State insurance risk pools may also qualify for tax exempt status under section 501(c)(4) as a social welfare organizations or under section 115 as serving an essential governmental function of a State. In seeking qualification under section 501(c)(4), insurance organizations generally are constrained by the restrictions on the provision of "commercial-type insurance" contained in section 501(m). Section 115 generally provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof. However, the IRS may be reluctant to rule that particular State risk-pooling entities satisfy the section 501(c)(4) or 115 requirements for tax-exempt status.

Description of Proposal

The proposal would clarify the tax-exempt status of any organization that is created by State law, and organized and operated exclusively to provide workmen's compensation insurance and related coverage that is incidental to workmen's compensation insurance. The workmen's compensation insurance must be required by State law, or be insurance with respect to which State law provides significant disincentives if it is not purchased by an employer. The organization must provide workmen's compensation to any employer in the State seeking such insurance and meeting other reasonable requirements. The State must either extend its full faith and credit to debt of the organization or provide the initial operating capital of the organization. The assets of the organization must revert to the State upon dissolution of the organization. Finally, the majority of the board of directors (or comparable oversight body) of the organization must be appointed by an official of the executive branch of the State or by the State legislature, or by both.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997. No inference would be intended as to prior law.

7. Exclusion from UBIT for certain corporate sponsorship payments

Present Law

Although generally exempt from Federal income tax, tax-exempt organizations are subject to the unrelated business income tax ("UBIT") on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions (secs. 511-514). Contributions or gifts received by tax-exempt organizations generally are not subject to the UBIT. However, present-law section 513(c) provides that an activity (such as advertising) does not lose its identity as a separate trade or business merely because it is carried on within a larger complex of other endeavors.[46] If a tax-exempt organization receives sponsorship payments in connection with an event or other activity, the solicitation and receipt of such sponsorship payments may be treated as a separate activity. The Internal Revenue Service (IRS) has taken the position that, under some circumstances, such sponsorship payments are subject to the UBIT.[47]

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[46] See United States v. American College of Physicians, 475 U.S. 834 (1986)(holding that activity of selling advertising in medical journal was not substantially related to the organization's exempt purposes and, as a separate business under section 513(c), was subject to tax).

[47] See Prop.Treas. Reg. sec. 1.513-4 (issued January 19, 1993, EE-74-92, IRB 1993-7, 71). These proposed regulations generally exclude from the UBIT financial arrangements under

Description of Proposal

Under the proposal, qualified sponsorship payments received by a tax-exempt organization (or State college or university described in section 511(a)(2)(B)) would be exempt from the UBIT.

"Qualified sponsorship payments" would be defined as any payment made by a person engaged in a trade or business with respect to which the person will receive no substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the person's trade or business in connection with the organization's activities.[48] Such a use or acknowledgment would not include advertising of such person's products or services -- meaning qualitative or comparative language, price information or other indications of savings or value, or an endorsement or other inducement to purchase, sell, or use such products or services. Thus, for example, if, in return for receiving a sponsorship payment, an organization promises to use the sponsor's name or logo in acknowledging the sponsor's support for an educational or fundraising event conducted by the organization, such payment would not be subject to the UBIT. In contrast, if the organization provides advertising of a sponsor's products, the payment made to the organization by the sponsor in order to receive such advertising would be subject to the UBIT (provided that the other, present-law requirements for UBIT liability are satisfied).

The proposal would specifically provide that a qualified sponsorship payment would not include any payment where the amount of such payment is contingent, by contract or otherwise, upon the level of attendance at an event, broadcast ratings, or other factors indicating the degree of public exposure to an activity. However, the fact that a sponsorship payment is contingent upon an event actually taking place or being broadcast, in and of itself, would not cause the payment to fail to be a qualified sponsorship payment. Moreover, mere distribution or display of a sponsor's products by the sponsor or the tax-exempt organization to the general public at a sponsored event, whether for free or for remuneration, would be considered to be "use or acknowledgment" of the sponsor's product lines (as opposed to advertising), and thus would not affect the determination of whether a payment made by the sponsor is a qualified sponsorship payment.

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which the tax-exempt organization provides so-called "institutional" or "good will" advertising to a sponsor (i.e., arrangements under which a sponsor's name, logo, or product line is acknowledged by the tax-exempt organization). However, specific product advertising (e.g., "comparative or qualitative descriptions of the sponsor's products") provided by a tax-exempt organization on behalf of a sponsor is not shielded from the UBIT under the proposed regulations.

[48] In determining whether a payment is a qualified sponsorship payment, it would be irrelevant whether the sponsored activity is related or unrelated to the organization's exempt purpose.

The proposal would not apply to the sale of advertising or acknowledgments in tax-exempt organization periodicals. For this purpose, the term "periodical" would mean regularly scheduled and printed material published by (or on behalf of) the payee organization that is not related to and primarily distributed in connection with a specific event conducted by the payee organization. For example, the proposal would not apply to payments that lead to acknowledgments in a monthly journal, but would apply if a sponsor receives an acknowledgment in a program or brochure distributed at a sponsored event.

The proposal would specifically provide that, to the extent that a portion of a payment would (if made as a separate payment) be a qualified sponsorship payment, such portion of the payment would be treated as a separate payment. Thus, if a sponsorship payment made to a tax-exempt organization entitles the sponsor to both product advertising <u>and</u> use or acknowledgment of the sponsor's name or logo by the organization, then the UBIT would not apply to the amount of such payment that exceeds the fair market value of the product advertising provided to the sponsor. Moreover, the provision of facilities, services or other privileges by an exempt organization to a sponsor or the sponsor's designees (e.g., complimentary tickets, pro-am playing spots in golf tournaments, or receptions for major donors) in connection with a sponsorship payment would not affect the determination of whether the payment is a qualified sponsorship payment. Rather, the provision of such goods or services would be evaluated as a separate transaction in determining whether the organization has unrelated business taxable income from the event. In general, if such services or facilities do not constitute a substantial return benefit or if the provision of such services or facilities is a related business activity, then the payments attributable to such services or facilities would not be subject to the UBIT. Moreover, just as the provision of facilities, services or other privileges by a tax-exempt organization to a sponsor or the sponsor's designees (complimentary tickets, pro-am playing spots in golf tournaments, or receptions for major donors) would be treated as a separate transaction that does not affect the determination of whether a sponsorship payment is a qualified sponsorship payment, a sponsor's receipt of a license to use an intangible asset (e.g., trademark, logo, or designation) of the tax-exempt organization likewise would be treated as separate from the qualified sponsorship transaction in determining whether the organization has unrelated business taxable income.

The exemption provided by the proposal would be in addition to other present-law exceptions from the UBIT (e.g., the exceptions for activities substantially all the work for which is performed by volunteers and for activities not regularly carried on). No inference would be intended as to whether any sponsorship payment received prior to 1998 was subject to the UBIT.

Effective Date

The proposal would apply to qualified sponsorship payments solicited or received after December 31, 1997.

8. Increase in standard mileage rate for purposes of computing charitable deduction

Present Law

In general, individuals who itemize their deductions may deduct charitable contributions. For purposes of computing the charitable deduction for the use of a passenger automobile, the standard mileage rate is 12 cents per mile (sec. 170(i)).

Description of Proposal

The proposal would increase this mileage rate to 15 cents per mile. This rate would be indexed for inflation, rounded down to the nearest whole cent.

Effective Date

The increase to 15 cents would be effective for taxable years beginning after December 31, 1997. The indexation would be effective for inflation occurring after 1997. Accordingly, the first adjustment for indexing would occur in 1999 to reflect inflation in 1998.

9. Allow timeshare associations to elect to be taxed as homeowners' associations

Present Law

Taxation of homeowners' associations making the section 528 election.--Under present law (sec. 528), condominium management associations and residential real estate management associations may elect to be taxable at a 30 percent rate on their "homeowners' association income" if they meet certain income, expenditure, and organizational requirements.

"Homeowners' association income" is the excess of the association's gross income, excluding "exempt function income," over allowable deductions directly connected with non-exempt function gross income. "Exempt function income" includes membership dues, fees, and assessments for a common activity undertaken by association members or owners of residential units in the condominium or subdivision. Homeowners' association income includes passive income (interest and dividends) earned on reserves and fees for use of association property (e.g., swimming pools, meeting rooms, etc.).

In order to qualify for this treatment, at least 60 percent of the association's gross income must consist of membership dues, fees, or assessments on owners, at least 90 percent of its expenditures must be for the acquisition, management, maintenance, or care of "association property," and no part of its net earnings can inure to the benefit of any private shareholder. "Association property" means (1) property held by the association, (2) property commonly held by association members, (3) property within the association privately held by association members, and (4) property held by a governmental unit for the benefit of association members. In addition to these statutory requirements, Treasury regulations require that the units of the association be used for residential purposes. Use is not a residential use if the unit is occupied by a person or series of persons less than 30 days for more than half of the association's taxable year. Treas. reg. sec. 1.528-4(d).

Taxation of homeowners' associations **not** making the section 528 election.--Homeowners' associations that do not (or cannot) make the section 528 election are taxed either as a tax-exempt social welfare organization under sec. 501(c)(4) or as a regular C corporation. In order for an organization to qualify as a tax-exempt social welfare organization, the organization must meet the following three requirements: (1) the association must serve a "community" which bears a reasonable, recognizable relationship to an area ordinarily identified as a governmental subdivision or unit; (2) the association may not conduct activities directed to exterior maintenance of any private residence, and (3) common areas of association facilities must be for the use and enjoyment of the general public (Rev. Rul. 74-99, 1974-1 C.B. 131).

Non-exempt homeowners' associations are taxed as C corporations, except that (1) the association may exclude excess assessments that it refunds to its members or applies to the subsequent year's assessments (Rev. Rul. 70-604, 1970-2 C.B. 9); (2) gross income does not include special assessments held in a special bank account (Rev. Rul. 75-370, 75-2 C.B. 25), and (3) assessments for capital improvements are treated as non-taxable contributions to capital (Rev. Rul. 75-370, 1975-2 C.B. 25).

Taxation of timeshare associations.--Under present law, timeshare associations are taxed as regular C corporations because (1) they cannot meet the requirement of the Treasury regulations for the section 528 election that the units be used for residential purposes (i.e., the 30-day rule) and they have relatively large amount of services performed for its owners (e.g., maid and janitorial services) and (2) they cannot meet any of requirements of Rev. Rul. 74-99 for tax-exempt status under section 501(c)(4). In addition, the IRS recently has challenged the exclusions from gross income as a C corporation of refunds of excess assessments, special assessments held in a segregated account, and capital assessments as contributions to capital. See P.L.R. 9539001 (June 8, 1995) and the taxpayer's protest.

Description of Proposal

The proposal would amend section 528 to permit timeshare associations to qualify for taxation under that section. Timeshare associations would have to meet the other requirements of section 528 (e.g., the 60 percent gross income, 90 percent expenditure, and the non-profit organization and operation basis requirements) and be subject to a 32 percent tax rate.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1996.

10. Modification of passive foreign investment company provisions to eliminate overlap with subpart F and to allow mark-to-market election

Present Law

Overview

U.S. citizens and residents and U.S. corporations (collectively, "U.S. persons") are taxed currently by the United States on their worldwide income, subject to a credit against U.S. tax on foreign income based on foreign income taxes paid with respect to such income. A foreign corporation generally is not subject to U.S. tax on its income from operations outside the United States.

Income of a foreign corporation generally is taxed by the United States when it is repatriated to the United States through payment to the corporation's U.S. stockholders, subject to a foreign tax credit. However, a variety of regimes imposing current U.S. tax on income earned through a foreign corporation have been reflected in the Code. Today the principal anti-deferral regimes set forth in the Code are the controlled foreign corporation rules of subpart F (secs. 951-964) and the passive foreign investment company rules (secs. 1291-1297). Additional anti-deferral regimes set forth in the Code are the foreign personal holding company rules (secs. 551-558); the personal holding company rules (secs. 541-547); the accumulated earnings tax (secs. 531-537); and the foreign investment company and electing foreign investment company rules (secs. 1246-1247). The anti-deferral regimes included in the Code overlap such that a given taxpayer may be subject to multiple sets of anti-deferral rules.

Controlled foreign corporations

A controlled foreign corporation (CFC) is defined generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only) (sec. 957). Stock ownership includes not only stock owned directly, but also all stock owned indirectly or constructively (sec. 958).

Certain income of a CFC (referred to as "subpart F income") is subject to current U.S. tax under the Code's subpart F provisions. The United States generally taxes the corporation's U.S. 10-percent shareholders currently on their pro rata shares of the subpart F income. In effect, those U.S. shareholders are treated as having received a current distribution out of the CFC's subpart F income. Such shareholders also are subject to current U.S. tax on their pro rata shares of the CFC's earnings invested in U.S. property. The foreign tax credit may reduce the U.S. tax on these amounts.

Passive foreign investment companies

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies (PFICs). A PFIC is any foreign corporation if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average fair market value of its assets consists of assets that produce, or are held for the production of, passive income. Two alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC. One set of rules applies to PFICs that are "qualified electing funds," under which electing U.S. shareholders include currently in gross income their respective shares of a PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not qualified electing funds ("nonqualified funds"), under which the U.S. shareholders pay tax on income realized from a PFIC and an interest charge that is attributable to the value of deferral.

Overlap between subpart F and the PFIC provisions

A foreign corporation that is a CFC is also a PFIC if it meets the passive income test or the passive assets test described above. In such a case, the U.S. 10-percent shareholders are subject both to the subpart F provisions (which require current inclusion of certain earnings of the corporation) and to the PFIC provisions (which impose an interest charge on amounts distributed from the corporation and gains recognized upon the disposition of the corporation's stock, unless an election is made to include currently all of the corporation's earnings).

Description of Proposal

Elimination of overlap between subpart F and the PFIC provisions

In the case of a PFIC that is also a CFC, the proposal generally would treat the corporation as not a PFIC with respect to certain 10-percent shareholders. This rule would apply if the corporation is a CFC (within the meaning of section 957(a)) and the shareholder is a U.S. shareholder (within the meaning of section 951(b)) of such corporation (i.e., if the shareholder is subject to the current inclusion rules of subpart F with respect to such corporation). Moreover, the rule would apply for that portion of the shareholder's holding period with respect to the corporation's stock which is after December 31, 1997 and during which the corporation is a CFC and the shareholder is a U.S. shareholder. Accordingly, a shareholder that is subject to current inclusion under the subpart F rules with respect to stock of a PFIC that is also a CFC generally would not be subject also to the PFIC provisions with respect to the same stock. As under present law, the PFIC provisions would continue to apply in the case of a PFIC that is also a CFC to shareholders that are not subject to subpart F (i.e., to shareholders that are U.S. persons and that own (directly, indirectly, or constructively) less than 10 percent of the corporation's stock by vote).

If a shareholder of a PFIC is subject to the rules applicable to nonqualified funds before becoming eligible for the special rules provided under the proposal for shareholders that are subject to subpart F, the stock held by such shareholder would continue to be treated as PFIC stock unless the shareholder makes an election to pay tax and an interest charge with respect to the unrealized appreciation in the stock or the accumulated earnings of the corporation.

If, under the proposal, a shareholder is not subject to the PFIC provisions because the shareholder is subject to subpart F and the shareholder subsequently ceases to be subject to subpart F with respect to the corporation, for purposes of the PFIC provisions, the shareholder's holding period for such stock would be treated as beginning immediately after such cessation. Accordingly, in applying the rules applicable to PFICs that are not qualified electing funds, the earnings of the corporation would not be attributed to the period during which the shareholder was subject to subpart F with respect to the corporation and was not subject to the PFIC provisions.

Mark-to-market election

The proposal would allow a shareholder of a PFIC to make a mark-to-market election with respect to the stock of the PFIC, provided that such stock is marketable (as defined below). Under such an election, the shareholder would include in income each year an amount equal to the excess, if any, of the fair market value of the PFIC stock as of the close of the taxable year over the shareholder's adjusted basis in such stock. The shareholder would be allowed a deduction for the excess, if any, of the adjusted basis of the PFIC stock over its fair market value as of the close of the taxable year. However, deductions would be allowable under this rule only to the extent of any net mark-to-market gains with respect to the stock included by the shareholder for prior taxable years.

Under the proposal, this mark-to-market election would be available only for PFIC stock that is "marketable." For this purpose, PFIC stock would be considered marketable if it is regularly traded on a national securities exchange that is registered with the Securities and Exchange Commission or on the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934. In addition, PFIC stock would be considered marketable if it is regularly traded on any exchange or market that the Secretary of the Treasury determines has rules sufficient to ensure that the market price represents a legitimate and sound fair market value. Any option on stock that is considered marketable under the foregoing rules would be treated as marketable, to the extent provided in regulations. PFIC stock also would be treated as marketable, to the extent provided in regulations, if the PFIC offers for sale (or has outstanding) stock of which it is the issuer and which is redeemable at its net asset value in a manner comparable to a U.S. regulated investment company (RIC).

In addition, the proposal would treat as marketable any PFIC stock owned by a RIC that offers for sale (or has outstanding) any stock of which it is the issuer and which is redeemable at its net asset value. The bill would treat as marketable any PFIC stock held by any other RIC that otherwise publishes net asset valuations at least annually, except to the extent provided in regulations.

The shareholder's adjusted basis in the PFIC stock would be adjusted to reflect the amounts included or deducted under this election. In the case of stock owned indirectly by a U.S. person through a foreign entity (as discussed below), the basis adjustments for mark-to-market gains and losses would apply to the basis of the PFIC in the hands of the intermediary owner, but only for purposes of the subsequent application of the PFIC rules to the tax treatment of the indirect U.S. owner. In addition, similar basis adjustments would be made to the adjusted basis of the property actually held by the U.S. person by reason of which the U.S. person is treated as owning PFIC stock.

Amounts included in income pursuant to a mark-to-market election, as well as gain on the actual sale or other disposition of the PFIC stock, would be treated as ordinary income. Ordinary loss treatment also would apply to the deductible portion of any mark-to-market loss on PFIC stock, as well as to any loss realized on the actual sale or other disposition of PFIC stock to the extent that the amount of such loss does not exceed the net mark-to-market gains previously included with respect to such stock. The source of amounts with respect to a mark-to-market election generally would be determined in the same manner as if such amounts were gain or loss from the sale of stock in the PFIC.

An election to mark to market would apply to the taxable year for which made and all subsequent taxable years, unless the PFIC stock ceases to be marketable or the Secretary of the Treasury consents to the revocation of such election.

Under constructive ownership rules, U.S. persons that own PFIC stock through certain foreign entities could make this election with respect to the PFIC. These constructive ownership rules would apply to treat PFIC stock owned directly or indirectly by or for a foreign partnership, trust, or estate as owned proportionately by the partners or beneficiaries, except as provided in regulations. Stock in a PFIC that is thus treated as owned by a person would be treated as actually owned by that person for purposes of again applying the constructive ownership rules. In the case of a U.S. person that is treated as owning PFIC stock by application of this constructive ownership rule, any disposition by the U.S. person or by any other person that results in the U.S. person being treated as no longer owning the PFIC stock, as well as any disposition by the person actually owning the PFIC stock, would be treated as a disposition by the U.S. person of the PFIC stock.

In addition, a CFC that owns stock in a PFIC would be treated as a U.S. person that could make the election with respect to such PFIC stock. Any amount includible (or deductible) in the CFC's gross income pursuant to this mark-to-market election would be treated as foreign personal holding company income (or a deduction allocable to foreign personal holding company income). The source of such amounts, however, would be determined by reference to the actual residence of the CFC.

In the case of a taxpayer that makes the mark-to-market election with respect to stock in a PFIC that is a nonqualified fund after the beginning of the taxpayer's holding period with respect to such stock, a coordination rule would apply to ensure that the taxpayer does not avoid the interest charge with respect to amounts attributable to periods before such election. A similar rule would apply to RICs that make the mark-to-market election under this bill after the beginning of their holding period with respect to PFIC stock (to the extent that the regulated investment company had not previously marked to market the stock of the PFIC).

Except as provided in the coordination rules described above, the rules of section 1291 (with respect to nonqualified funds) would not apply to a shareholder of a PFIC if a mark-to-market election is in effect for the shareholder's taxable year. Moreover, in applying section 1291 in a case where a mark-to-market election was in effect for any prior taxable year, the shareholder's holding period for the PFIC stock would be treated as beginning immediately after the last taxable year for which such election applied.

A special rule applicable in the case of a PFIC shareholder that becomes a U.S. person would treat the adjusted basis of any PFIC stock held by such person on the first day of the year in which such shareholder becomes a U.S. person as equal to the greater of its fair market value on such date or its adjusted basis on such date. Such rule would apply only for purposes of the mark-to-market election.

Effective Date

The proposal would be effective for taxable years of U.S. persons beginning after December 31, 1997, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

11. Eligibility of licenses of computer software for foreign sales corporation benefits

Present Law

Under special tax provisions that provide an export benefit, a portion of the foreign trade income of an eligible foreign sales corporation ("FSC") is exempt from Federal income tax. Foreign trade income is defined as the gross income of a FSC that is attributable to foreign trading gross receipts. The term "foreign trading gross receipts" includes the gross receipts of a FSC from the sale, lease, or rental of export property and from services related and subsidiary to such sales, leases, or rentals.

For purposes of the FSC rules, export property is defined as property (1) which is manufactured, produced, grown, or extracted in the United States by a person other than a FSC; (2) which is held primarily for sale, lease, or rental in the ordinary conduct of a trade or business by or to a FSC for direct use, consumption, or disposition outside the United States; and (3) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States. Intangible property generally is excluded from the definition of export property for purposes of the FSC rules; this exclusion applies to copyrights <u>other than</u> films, tapes, records, or similar reproductions for commercial or home use. The temporary Treasury regulations provide that a license of a master recording tape for reproduction outside the United States is not excluded from the definition of export property (Treas. Reg. sec. 1.927(a)-1T(f)(3)). The statutory exclusion for intangible property does not contain any specific reference to computer software. However, the temporary Treasury regulations provide that a copyright on computer software does not constitute export property, and that standardized, mass marketed computer software constitutes export property if such software is not accompanied by a right to reproduce for external use (Treas. Reg. sec. 1.927(a)-1T(f)(3)).

Description of Proposal

The proposal provides that computer software licensed for reproduction abroad would <u>not</u> be excluded from the definition of export property for purposes of the FSC provisions. Accordingly, computer software that is exported with a right to reproduce would be eligible for the benefits of the FSC provisions. In light of the rapid innovations in the computer and software industries, it would be intended that the term "computer software" be construed broadly to accommodate technological changes in the products produced by both industries. No inference would be intended regarding the qualification as export property of computer software licensed for reproduction abroad under present law.

Effective Date

The proposal generally would apply to gross receipts from computer software licenses attributable to periods after December 31, 1997. Accordingly, in the case of a multi-year license, the proposal would apply to gross receipts attributable to the period of such license that is after December 31, 1997. However, in the case of gross receipts attributable to calendar year 1998, the proposal would apply to only one-third of such gross receipts. In the case of gross receipts attributable to calendar year 1999, the proposal would apply to only two-thirds of such gross receipts.

12. Treatment of certain securities positions under the subpart F investment in U.S. property rules

Present Law

Under the rules of subpart F (secs. 951-964), certain U.S. 10-percent shareholders of a controlled foreign corporation (CFC) are required to include in income currently for U.S. tax purposes certain earnings of the CFC, whether or not such earnings are distributed currently to the shareholders. The U.S. 10-percent shareholders of a CFC are subject to current U.S. tax on their shares of certain income earned by the CFC (referred to as "subpart F income"). The U.S. 10-percent shareholders also are subject to current U.S. tax on their shares of the CFC's earnings to the extent invested by the CFC in certain U.S. property.

A shareholder's current income inclusion with respect to a CFC's investment in U.S. property for a taxable year is based on the CFC's average investment in U.S. property for such year. For this purpose, the U.S. property held by the CFC must be measured as of the close of each quarter in the taxable year. U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, obligations of a U.S. person, and the right to use certain intellectual property in the United States. Exceptions are provided for, among other things, obligations of the United States. U.S. bank deposits, certain trade or business obligations, and stock or debts of certain unrelated U.S. corporations.

Description of Proposal

The proposal would provide two additional exceptions from the definition of U.S. property for purposes of the subpart F rules. Both exceptions relate to transactions entered into by a securities or commodities dealer in the ordinary course of its business as a securities or commodities dealer.

The first exception would cover the deposit of collateral or margin by a securities or commodities dealer, or the receipt of such a deposit by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer. This exception would apply to deposits of margin or collateral for securities loans, notional principal contracts, options contracts, forward contracts, futures contracts, and any other financial transaction with respect to which the Secretary of the Treasury determines that the posting of collateral or margin is customary.

The second exception would cover repurchase agreement transactions and reverse repurchase agreement transactions entered into by or with a securities or commodities dealer in the ordinary course of its business as a securities or commodities dealer. The exception would apply only to the extent that the obligation under the transaction does not exceed the fair market value of readily marketable securities transferred or otherwise posted as collateral.

Effective Date

The proposal would be effective for taxable years of U.S. persons beginning after December 31, 1997, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

13. Regulations to limit treaty benefits for payments to hybrid entities

Present Law

Nonresident alien individuals and foreign corporations (collectively, foreign persons) that are engaged in business in the United States are subject to U.S. tax on the income from such business in the same manner as a U.S. person. In addition, the United States imposes tax on certain types of U.S. source income, including interest, dividends and royalties, of foreign persons not engaged in business in the United States. Such tax is imposed on a gross basis and is collected through withholding. The statutory rate of this withholding tax is 30 percent. However, most U.S. income tax treaties provide for a reduction in the rate, or elimination, of this withholding tax. Treaties generally provide for different applicable withholding tax rates for different types of income. Moreover, the applicable withholding tax rates differ among treaties. The specific withholding tax rates pursuant to a treaty are the result of negotiations between the United States and the treaty partner.

The application of the withholding tax is more complicated in the case of income derived through an entity, such as a limited liability company, that is treated as a partnership for U.S. tax purposes but may be treated as a corporation for purposes of the tax laws of a treaty partner. The Treasury regulations include specific rules that apply in the case of income derived through an entity that is treated as a partnership for U.S. tax purposes. In the case of a payment of an item of U.S. source income to a U.S. partnership, the partnership is required to impose the withholding tax to the extent the item of income is includible in the distributive share of a partner who is a foreign person. Tax-avoidance opportunities may arise in applying the reduced rates of withholding tax provided under a treaty to cases involving income derived through a limited liability company or other hybrid entity (e.g., an entity that is treated as a partnership for U.S. tax purposes but as a corporation for purposes of the treaty partner's tax laws). Regulations that have been proposed but not yet finalized would address this issue in the case of an item received by a foreign entity by allowing an interest holder in that entity to claim a reduced rate of withholding tax with respect to that item under a treaty only if the treaty partner requires the interest holder to include in income its distributive share of the entity's income on a flow-through basis. Prop. Treas. Reg. Sec. 1.1441-6(b)(4). This provision in the proposed regulations does not apply in the case of a U.S. entity.

Description of Proposal

The proposal would provide that the Secretary of the Treasury shall prescribe regulations to determine the extent to which a taxpayer shall be denied benefits under an income tax treaty of the United States with respect to any payment received by, or income attributable to activities of, an entity that is treated as a partnership for U.S. federal income tax purposes (or is otherwise treated as fiscally transparent for such purposes) but is treated as fiscally non-transparent for purposes of the tax laws of the jurisdiction of residence of the taxpayer.

This proposal would address the potential tax-avoidance opportunity that may arise in applying the reduced rates of withholding tax provided under a treaty to cases involving income derived through a limited liability company or other hybrid entity (e.g., an entity that is treated as a partnership for U.S. tax purposes but as a corporation for purposes of the treaty partner's tax laws). Such a tax-avoidance opportunity may arise, for example, for Canadian corporations with U.S. subsidiaries because of the interaction between the U.S. tax law, the Canadian tax law, and the income tax treaty between the United States and Canada. Through the use of a U.S. limited liability company, which is treated as a partnership for U.S. tax purposes but as a corporation for Canadian tax purposes, a payment of interest (which is deductible for U.S. tax purposes) may be converted into a dividend (which is excludable for Canadian tax purposes). Accordingly, interest paid by a U.S. subsidiary through a U.S. limited liability company to a Canadian parent corporation would be deducted by the U.S. subsidiary for U.S. tax purposes and would be excluded by the Canadian parent corporation for Canadian tax purposes; the only tax on such interest would be a U.S. withholding tax, which may be imposed at a reduced rate of 10 percent (rather than the full statutory rate of 30 percent) pursuant to the income tax treaty between the United States and Canada. It is expected that the regulations would impose withholding tax at the full statutory rate of 30 percent in such case.

Effective Date

The proposal would be effective upon date of enactment.

14. Tax certain alternative fuels based on energy equivalency to gasoline

Present Law

Excise taxes are imposed on gasoline, diesel fuel, and special motor fuels used in highway vehicles. 4.3 cents per gallon of each of these taxes is retained in the General Fund, with the balance of the revenues being dedicated to one or more Trust Funds. The tax on gasoline is 18.3 cents per gallon; the tax on diesel fuel is 24.3 cents per gallon; and the tax on special motor fuels generally is 18.3 cents per gallon. Taxable special motor fuels include liquefied petroleum gas ("propane"), liquefied natural gas ("LNG"), methanol from natural gas, and compressed natural gas ("CNG"). Special rates apply to methanol from natural gas (exempt from 7 cents of the 14-cents-per-gallon Highway Trust Fund component of the special motor fuels tax), and compressed natural gas (exempt from the entire Highway Trust Fund component of the tax).

In general, these four special motor fuels contain less energy (i.e., fewer Btu's) per gallon than does gasoline.

Description of Proposal

The tax rates on propane, LNG, and methanol from natural gas would be adjusted to reflect the respective energy equivalence of the fuels to gasoline.

Effective Date

The proposal would be effective for fuels sold or used after September 30, 1997.

15. Repeal excise tax on diesel fuel used in recreational motorboats

Present Law

Before a temporary suspension through December 31, 1997 was enacted in 1996, diesel fuel used in recreational motorboats was subject to the 24.3-cents-per-gallon diesel fuel excise tax. Revenues from this tax were retained in the General Fund. The tax was enacted by the Omnibus Budget Reconciliation Act of 1993 as a revenue offset for repeal of the excise tax on certain luxury boats.

Description of Proposal

The proposal would repeal the application of the diesel fuel tax to fuel used in recreational motorboats.

Effective Date

The proposal would be effective for fuel sold after December 31, 1997.

16. Expensing of environmental remediation costs ("brownfields")

Present Law

Code section 162 allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Treasury Regulations provide that the cost of incidental repairs which neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense. Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury Regulations define "capital expenditures" as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use. Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

Treasury regulations provide that capital expenditures include the costs of acquiring or substantially improving buildings, machinery, equipment, furniture, fixtures and similar property having a useful life substantially beyond the current year. In INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992), the Supreme Court required the capitalization of legal fees incurred by a taxpayer in connection with a friendly takeover by one of its customers on the grounds that the merger would produce significant economic benefits to the taxpayer extending beyond the current year; capitalization of the costs thus would match the expenditures with the income produced. Similarly, the amount paid for the construction of a filtration plant, with a life extending beyond the year of completion, and as a permanent addition to the taxpayer's mill property, was a capital expenditure rather than an ordinary and necessary current business expense. Woolrich Woolen Mills v. United States, 289 F.2d 444 (3d Cir. 1961).

Although Treasury regulations provide that expenditures that materially increase the value of property must be capitalized, they do not set forth a method of determining how and when value has been increased. In Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962), nonacq., 1964-2 C.B. 8, the U.S. Tax Court held that increased value was determined by comparing the value of an asset after the expenditure with its value before the condition necessitating the expenditure. The Tax Court stated that "an expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair."

In several Technical Advice Memoranda (TAM), the Internal Revenue Service (IRS) declined to apply the Plainfield Union valuation analysis, indicating that the analysis represents just one of several alternative methods of determining increases in the value of an asset. In TAM 9240004 (June 29, 1992), the IRS required certain asbestos removal costs to be capitalized rather than expensed. In that instance, the taxpayer owned equipment that was manufactured with insulation containing asbestos; the taxpayer replaced the asbestos insulation with less thermally efficient, non-asbestos insulation. The IRS concluded that the expenditures resulted in a material increase in the value of the equipment because the asbestos removal eliminated human health risks, reduced the risk of liability to employees resulting from the contamination, and made the property more marketable. Similarly, in TAM 9411002 (November 19, 1993), the IRS required the capitalization of expenditures to remove and replace asbestos in connection with the conversion of a boiler room to garage and office space. However, the IRS permitted deduction of costs of encapsulating exposed asbestos in an adjacent warehouse.

In 1994, the IRS issued Rev. Rul. 94-38, 1994-1 C.B. 35, holding that soil remediation expenditures and ongoing water treatment expenditures incurred to clean up land and water that a taxpayer contaminated with hazardous waste are deductible. In this ruling, the IRS explicitly accepted the Plainfield Union valuation analysis.[49] However, the IRS also held that costs allocable to constructing a groundwater treatment facility are capital expenditures.

In 1995, the IRS issued TAM 9541005 (October 13, 1995) requiring a taxpayer to capitalize certain environmental study costs, as well as associated consulting and legal fees. The taxpayer acquired the land and conducted activities causing hazardous waste contamination. After the contamination, but before it was discovered, the company donated the land to the county to be developed into a recreational park. After the county discovered the contamination, it reconveyed the land to the company for $1. The company incurred the costs in developing a

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[49] Rev. Rul. 94-38 generally rendered moot the holding in TAM 9315004 (December 17, 1992) requiring a taxpayer to capitalize certain costs associated with the remediation of soil contaminated with polychlorinated biphenyls (PCBs).

remediation strategy. The IRS held that the costs were not deductible under section 162 because the company acquired the land in a contaminated state when it purchased the land from the county. In January, 1996, the IRS revoked and superseded TAM 9541005 (PLR 9627002). Noting that the company's contamination of the land and liability for remediation were unchanged during the break in ownership by the county, the IRS concluded that the break in ownership should not, in and of itself, operate to disallow a deduction under section 162.

Description of Proposal

The proposal would provide that taxpayers could elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The deduction would apply for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site would not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property which would otherwise be allocated to the site under the principles set forth in Comm'r v. Idaho Power Co.[50] and section 263A would be treated as qualified environmental remediation expenditures.

A "qualified contaminated site" generally would be any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). Targeted areas would mean (1) empowerment zones and enterprise communities (as designated under present law and the D.C. Enterprise Zone to be designated under the proposal); and (2) sites announced before February, 1997, as being subject to one of the 76 Environmental Protection Agency (EPA) Brownfields Pilots.

Both urban and rural sites would qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) could not be targeted areas. Appropriate State environmental agencies would be designated by the EPA; if no State agency is designated, the EPA would be responsible for providing the certification. Hazardous substances generally would be defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain natually occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use.

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[50] Comm'r v. Idaho Power Co., 418 U.S. 1 (1974) (holding that equipment depreciation allocable to the taxpayer's construction of capital facilities must be capitalized under section 263(a)(1)).

The proposal further would provide that, in the case of property to which a qualified environmental remediation expenditure otherwise would have be capitalized, any deduction allowed under the proposal would be treated as a depreciation deduction and the property would be treated as subject to section 1245. Thus, deductions for qualified environmental remediation expenditures would be subject to recapture as ordinary income upon sale or other disposition of the property.

Effective Date

The proposal would apply to eligible expenditures incurred after the date of enactment.

17. Provide a lower rate of alcohol excise tax on certain hard ciders

Present Law

Distilled spirits are taxed at a rate of $13.50 per proof gallon; beer is taxed at a rate of $18 per barrel (approximately 58 cents per gallon); and still wines of 14 percent alcohol or less are taxed at a rate of $1.07 per wine gallon. Higher rates of tax are applied to wines with greater alcohol content and sparkling wines.

Certain small wineries may claim a credit against the excise tax on wine of 90 cents per wine gallon on the first 100,000 gallons of wine produced annually. Certain small breweries pay a reduced tax of $7.00 per barrel (approximately 22.6 cents per gallon) on the first 60,000 barrels of beer produced annually.

Apple cider containing alcohol ("hard cider") is classified and taxed as wine.

Description of Proposal

The proposal would adjust the tax rate on apple cider having an alcohol content of no more than seven percent to 22.6 cents per gallon.

Effective Date

The proposal would be effective for hard cider removed after September 30, 1997.

18. Rules relating to denial of earned income credit on basis of disqualified income

Present Law

For taxable years beginning after December 31, 1995, an individual is not eligible for the earned income credit if the aggregate amount of "disqualified income" of the taxpayer for the taxable year exceeds $2,200. This threshold is indexed for inflation. Disqualified income is the sum of:

(1) interest (taxable and tax-exempt);
(2) dividends;
(3) net recent and royalty income (if greater than zero);
(4) capital gain net income and;
(5) net passive income (if greater than zero) that is not self-employment income.

Description of Proposal

The proposal would clarify that gain or loss from the sale of livestock (as defined under section 1231(b)(3) of the Code) is disregarded for purposes of the calculation of capital gain net income under the disqualified income test of the earned income credit.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1995.

19. Treatment of livestock sold on account of weather-related conditions

Present Law

In general, cash-method taxpayers report income in the year it is actually or constructively received. However, present law contains two special rules applicable to livestock sold on account of drought conditions. Code section 451(e) provides that a cash-method taxpayer whose principal trade or business is farming who is forced to sell livestock due to drought conditions may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought conditions that resulted in the area being designated as eligible for Federal assistance. This exception is generally intended to put taxpayers who receive an unusually high amount of income in one year in the position they would have been in absent the drought.

In addition, the sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought conditions is treated as an involuntary conversion under section 1033(e). Consequently, gain from the sale of such livestock could be deferred by reinvesting the proceeds of the sale in similar property within a two-year period.

Description of Proposal

The proposal would amend Code section 451(e) to provide that a cash-method taxpayer whose principal trade or business is farming and who is forced to sell livestock due not only to drought (as under present law), but also to floods or other weather-related conditions, may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income would be available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for the drought, flood or other weather-related conditions that resulted in the area being designated as eligible for Federal assistance.

In addition, the proposal would amend Code section 1033(e) to provide that the sale of livestock (other than poultry) that are held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought (as under present law), flood or other weather-related conditions is treated as an involuntary conversion.

Effective Date

The proposal would apply to sales and exchanges after December 31, 1996.

20. Repeal installment method adjustment for farmers

Present Law

The installment method allows gain on the sale of property to be recognized as payments are received. Under the regular tax, dealers in personal property are not allowed to defer the recognition of income by use of the installment method on the installment sale of such property. For this purpose, dealer dispositions do not include sales of any property used or produced in the trade or business of farming. For alternative minimum tax purposes, the installment method is not available with respect to the disposition of any property that is the stock in trade of the taxpayer or any other property of a kind which would be properly included in the inventory of the taxpayer if held at year end, or property held by the taxpayer primarily for sale to customers. No explicit exception is provided for installment sales of farm property under the alternative minimum tax.

Description of Proposal

The proposal would generally provide that for purposes of the alternative minimum tax, farmers may use the installment method of accounting.

Effective Date

The proposal generally would be effective for dispositions in taxable years beginning after December 31, 1987.

21. Study feasibility of moving collection point for distilled spirits excise tax

Present Law

Distilled spirits are subject to tax at $13.50 per proof gallon. (A proof gallon is a liquid gallon consisting of 50 percent alcohol.) In the case of domestically produced distilled spirits and distilled spirits imported in to the United States in bulk containers for domestic bottling, the tax is imposed on removal of the beverage from the distillery (without regard to whether a sale occurs at that time). Bottled distilled spirits that are imported into the United States comprise approximately 15 percent of the current market for these beverages; tax is imposed on these imports when the distilled spirits are removed from the first customs bonded warehouse in which they are deposited upon entry into the United States.

In the case of certain distilled spirits products, a tax credit for alcohol derived from fruit is allowed. This credit reduces the effective tax paid on those beverages. The credit is determined when the tax is paid (i.e., at the distillery or on importation).

Description of Proposal

The Bureau of Alcohol, Tobacco, and Firearms (the "BATF") would be directed develop and study options for changing the point at which the distilled spirits excise tax is collected. One of the options reviewed should be collecting the tax at the point at which the distilled spirits are removed from registered wholesale warehouses. As part of this study, the BATF should focus on administrative issues associated with the identified options, including the effects of tax compliance. The study should address the number of taxpayers involved, the types of financial responsibility requirements that might be needed, any special requirements regarding segregation of non-tax-paid distilled spirits from other products carried by the potential new taxpayers. The study further should review the effects of the proposal on BATF staffing and other budgetary resources as well as projections of the time between when tax currently is collected and the time when tax would be collected under the options.

The study would be required to be completed and transmitted to the Committee on Finance and the Committee on Ways and Means no later than January 31, 1998.

22. Deduction for business meals while operating under Department of Transportation hours of service limitations

Present Law

Ordinary and necessary business expenses, as well as expenses incurred for the production of income are generally deductible, subject to a number of restrictions and limitations. The amount allowable as a deduction for food and beverage is limited to 50 percent of the otherwise deductible amount. Exceptions to this 50 percent rule are provided for food and beverages provided to crew members of certain vessels and offshore oil or gas platforms or drilling rigs.

Description of Proposal

The proposal would increase to 80 percent the deductible percentage of the cost of food and beverages consumed 1) while away from home by an individual during, or incident to, a period of duty subject to the hours of service limitations of the Department of Transportation and 2) by workers at remote seafood processing facilities located in the United States north of 53 degrees north latitude. A seafood processing facility is remote when there are insufficient eating facilities in the vicinity of the employer's premises.[51]

Individuals subject to the hours of service limitations of the Department of Transportation include:

(1) certain air transportation employees such as pilots, crew, dispatchers, mechanics, and control tower operators pursuant to Federal Aviation Administration regulations,
(2) interstate truck operators and interstate bus drivers pursuant to Department of Transportation regulations,
(3) certain railroad employees such as engineers, conductors, train crews, dispatchers and control operations personnel pursuant to Federal Railroad Administration regulations, and
(4) certain merchant mariners pursuant to Coast Guard regulations.

The increase in the deductible percentage would be phased in according to the following schedule:

Taxable years beginning in	Deductible percentage
1998, 1999	55 percent
2000, 2001	60 percent
2002, 2003	65 percent
2004, 2005	70 percent
2006, 2007	75 percent
2008 and thereafter	80 percent

Effective Date

The proposal would be effective for taxable years beginning after 1997.

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[51] See Treas. Reg. sec. 1.119-1(a)(2)(ii)(c) and 1.119-1(f)(Example 7).

23. Delay imposition of penalties for failure to make payments electronically through EFTPS until after June 30, 1998

Present Law

Employers are required to withhold income taxes and FICA taxes from wages paid to their employees. Employers also are liable for their portion of FICA taxes, excise taxes, and estimated payments of their corporate income tax liability.

The Code requires the development and implementation of an electronic fund transfer system to remit these taxes and convey deposit information directly to the Treasury (Code sec. 6302(h)[52]). The Electronic Federal Tax Payment System ("EFTPS") was developed by Treasury in response to this requirement.[53] Employers must enroll with one of two private contractors hired by the Treasury. After enrollment, employers generally initiate deposits either by telephone or by computer.

The new system is phased in over a period of years by increasing each year the percentage of total taxes subject to the new EFTPS system. For fiscal year 1994, 3 percent of the total taxes are required to be made by electronic fund transfer. These percentages increased gradually for fiscal years 1995 and 1996. For fiscal year 1996, the percentage was 20.1 percent (30 percent for excise taxes and corporate estimated tax payments). For fiscal year 1997, these percentages increased significantly, to 58.3 percent (60 percent for excise taxes and corporate estimated tax payments). The specific implementation method required to achieve the target percentages is set forth in Treasury regulations. Implementation began with the largest depositors.

Treasury had originally implemented the 1997 percentages by requiring that all employers who deposit more than $50,000 in 1995 must begin using EFTPS by January 1, 1997. The Small Business Job Protection Act of 1996 provided that the increase in the required percentages for fiscal year 1997 (which, pursuant to Treasury regulations, was to take effect on January 1, 1997) will not take effect until July 1, 1997.[54] This was done to provide additional time prior to implementation of the 1997 requirements so that employers could be better informed about their responsibilities.

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[52] This requirement was enacted in 1993 (sec. 523 of P.L. 103-182).

[53] Treasury had earlier developed TAXLINK as the prototype for EFTPS. TAXLINK has been operational for several years; EFTPS is currently operational. Employers currently using TAXLINK will ultimately be required to participate in EFTPS.

[54] Sec. 1809 of P.L. 104-188.

On June 2, 1997, the IRS announced[55] that it will not impose penalties through December 31, 1997, on businesses that make timely deposits using paper federal tax deposit coupons while converting to the EFTPS system.

Description of Proposal

The proposal would provide that no penalty shall be imposed solely by reason of a failure to use EFTPS during the period from July 1, 1997 through June 30, 1998, if the taxpayer was first required to use the EFTPS system on or after July 1, 1997.

Effective Date

The proposal would be effective on July 1, 1997.

24. Treatment of certain publicly traded partnerships

Present Law

A publicly traded partnership generally is treated as a corporation for Federal tax purposes (sec. 7704). An exception to the rule treating the partnership as a corporation applies if 90 percent of the partnership's gross income consists of "passive-type income," which includes (1) interest (other than interest derived in a financial or insurance business, or certain amounts determined on the basis of income or profits), (2) dividends, (3) real property rents (as defined for purposes of the provision), (4) gain from the sale or other disposition of real property, (5) income and gains relating to minerals and natural resources (as defined for purposes of the provision), and (6) gain from the sale or disposition of a capital asset (or certain trade or business property) held for the production of income of the foregoing types (subject to an exception for certain commodities income).

The exception for publicly traded partnerships with "passive-type income" does not apply to any partnership that would be described in section 851(a) of the Code (relating to regulated investment companies, or "RICs"), if that partnership were a domestic corporation. Thus, a publicly traded partnership that is registered under the Investment Company Act of 1940 generally is treated as a corporation under the provision. Nevertheless, if a principal activity of the partnership consists of buying and selling of commodities (other than inventory or property held primarily for sale to customers) or futures, forwards and options with respect to commodities, and 90 percent of the partnership's income is such income, then the partnership is not treated as a corporation.

[55] IR-97-32.

A publicly traded partnership is a partnership whose interests are (1) traded on an established securities market, or (2) readily tradable on a secondary market (or the substantial equivalent thereof).

Treasury regulations provide detailed guidance as to when an interest is treated as readily tradable on a secondary market or the substantial equivalent. Generally, an interest is so treated "if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market" (Treas. Reg. sec. 1.7704-1(c)(1)).

When the publicly traded partnership rules were enacted in 1987, a 10-year grandfather rule provided that the provisions apply to certain existing partnerships only for taxable years beginning after December 31, 1997.[56] An existing publicly traded partnership is any partnership, if (1) it was a publicly traded partnership on December 17, 1997, (2) a registration statement indicating that the partnership was to be a publicly traded partnership was filed with the Securities and Exchange Commission with respect to the partnership on or before December 17, 1987, or (3) with respect to the partnership, an application was filed with a State regulatory commission on or before December 31, 1987, seeking permission to restructure a portion of a corporation as a publicly traded partnership. A partnership that otherwise would be treated as an existing publicly traded partnership ceases to be so treated as of the first day after December 17, 1987, on which there has been an addition of a substantial new line of business with respect to such partnership. A rule is provided to coordinate this grandfather rule with the exception to the rule treating the partnership as a corporation applies if 90 percent of the partnership's gross income consists of passive-type income. The coordination rule provides that passive-type income exception applies only after the grandfather rule ceases to apply (whether by passage of time or because the partnership ceases to qualify for the grandfather rule).

Description of Proposal

In the case of an existing publicly traded partnership that elects under the proposal to be subject to a tax on gross income from the active conduct of a trade or business, the rule of present law treating a publicly traded partnership as a corporation would not apply. An existing publicly traded partnership would be any publicly traded partnership that is not treated as a corporation, so long as such treatment is not determined under the exception of Code section 7704(c) (relating to passive-type income and rules applicable to regulated investment companies). The election to be subject to the tax on gross trade or business income, once made, would remain in effect until revoked by the partnership, and could not be reinstated.

The tax would be 3.5 percent of the partnership's gross income from the active conduct of a trade or business. The partnership's gross trade or business income would include its share of

[56] Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203), sec. 10211(c).

gross trade or business income of any lower-tier partnership. The tax imposed under the proposal could not be offset by tax credits.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

25. Combined employment tax reporting demonstration project

Present Law

Traditionally, Federal tax forms are filed with the Federal government and State tax forms are filed with individual states. This necessitates duplication of items common to both returns. Some States have recently been working with the IRS to implement combined State and Federal reporting of certain types of items on one form as a way of reducing the burdens on taxpayers. The State of Montana and the IRS have cooperatively developed a system to combine State and Federal employment tax reporting on one form. The one form would contain exclusively Federal data, exclusively State data, and information common to both: the taxpayer's name, address, TIN, and signature.

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service ("IRS") to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Implementation of the combined Montana-Federal employment tax reporting project has been hindered because the IRS interprets section 6103 to apply that provision's restrictions on disclosure to information common to both the State and Federal portions of the combined form, although these restrictions would not apply to the State with respect to the State's use of State-requested information if that information were supplied separately to both the State and the IRS.

Description of Proposal

The proposal would permit implementation of a demonstration project to assess the feasibility and desirability of expanding combined reporting in the future. There would be several limitations on the demonstration project. First, it would be limited to the State of Montana and the IRS. Second, it would be limited to employment tax reporting. Third, it would be limited to disclosure of the name, address, TIN, and signature of the taxpayer. Fourth, it would be limited to a period of five years. General confidentiality restrictions would continue to apply.

Effective Date

The proposal would be effective on the date of enactment, and would expire on the date five years after the date of enactment.

26. Qualified small-issue bonds

Present Law

Interest on certain small issues of private activity bonds issued by State or local governments ("qualified small-issue bonds") is excluded from gross income if certain conditions are met. First, at least 95 percent of the bond proceeds must be used to finance manufacturing facilities or certain agricultural land or equipment. Second, the bond issue must have an aggregate face amount of $1 million or less, or alternatively, the aggregate face amount of the issue, together with the aggregate amount of certain related capital expenditures during the six-year period beginning three years before the date of the issue and ending three years after that date, must not exceed $10 million. (The maximum face amount of bonds would not be increased over present-law amounts.)

Issuance of qualified small-issue bonds, like most other private activity bonds, is subject to annual State volume limitations and to other rules.

Description of Proposal

The proposal would increase the maximum capital expenditure limit under present law from $10 million to $20 million.

Effective Date

The proposal would be effective for bonds issued after December 31, 1997.

VIII. REVENUE-INCREASE PROVISIONS

1. Extension and modification of Airport and Airway Trust Fund excise taxes

Present Law

Present law imposes a variety of excise taxes on air transportation to finance the Airport and Airway Trust Fund programs administered by the Federal Aviation Administration (the "FAA"). In general, the full cost of FAA capital programs is financed from the Airport and Airway Trust Fund, while only a portion of FAA operational expenses is Trust Fund-financed. Overall, the portion of total FAA expenditures that has been financed from the Trust Fund has declined from 75 percent through the early 1990s to 62 percent for the 1997 fiscal year. The balance is financed by general taxpayers, rather than directly by program users. Each of the Airport and Airway Trust Fund excise taxes is scheduled to expire after September 30, 1997.

Commercial air passenger transportation taxes

Domestic air passenger transportation is subject to an ad valorem excise tax equal to 10 percent of the amount paid for the transportation. Taxable domestic air transportation includes both travel within the United States and certain travel between the United States and points in Canada or Mexico that are within 225 miles of the U.S. border (the "225-mile zone").

Special rules apply to air transportation between the continental United States and Alaska or Hawaii and between Alaska and Hawaii. The portion of such transportation which is not within the United States (e.g., the portion over the Pacific Ocean between the continental West Coast or Alaska and Hawaii) is not subject to the 10-percent air passenger excise tax.[57] The 10-percent excise tax applies in full, however, to air transportation within the States of Alaska and Hawaii.

The 10-percent air passenger transportation excise tax also does not apply to domestic U.S. segments of uninterrupted international air transportation. Uninterrupted international air transportation includes only travel (entirely by air) that does not both begin and end in the United States (or in the 225-mile zone) and during which there is no more than a 12-hour scheduled period between arrival and departure at any intermediate point in the United States. For example, assume that a passenger travels from New York to Tokyo, with a four-hour stop and aircraft change in Seattle. The domestic segment of the flight (i.e., New York to Seattle) is not subject to the domestic air passenger transportation excise tax because that segment is a part of uninterrupted international air transportation.

International air passenger transportation is subject to a $6 departure excise tax imposed on passengers departing the United States for other countries. No tax is imposed on passengers

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[57] The $6 per passenger international departure excise tax, described below, does apply to this transportation.

arriving in the United States from other countries. As with passengers departing the United States, separate domestic flights of arriving passengers that connect from international flights are exempt from tax, provided that stopover time at any point within the United States does not exceed 12 hours.

Because both the domestic and international air passenger excise taxes are imposed only on transportation for which an amount is paid, no tax is imposed on "free" travel (e.g., frequent flyer travel and airline industry employee travel for which the passenger is not directly charged).

The air passenger transportation excise taxes are imposed on passengers; transportation providers (generally airlines) are responsible for collecting and remitting the taxes to the Federal Government. In general, both the domestic and international air passenger transportation excise taxes are imposed without regard to whether the transportation is purchased within the United States. An exception provides that travel between the United States and the 225-mile zone is subject to the ad valorem domestic tax only if it is purchased within the United States.

The amount of air passenger transportation excise tax collected from a passenger must be stated separately on the passenger's ticket.

Commercial air cargo transportation

Domestic air cargo transportation is subject to a 6.25-percent ad valorem excise tax. This tax, like the air passenger excise taxes, is imposed on the consumer, with the transportation provider being required to collect and remit the tax to the Federal Government. However, there is no requirement that the tax be stated separately on shipping invoices.

Noncommercial aviation

Noncommercial aviation, or transportation on private aircraft which is not "for hire," is subject to excise taxes imposed on fuel in lieu of the commercial air passenger ticket and air cargo excise taxes. The current Airport and Airway Trust Fund tax rates on these fuels are 15 cents per gallon on aviation gasoline and 17.5 cents per gallon on jet fuel.

The aviation gasoline excise tax is imposed on removal of the fuel from a registered terminal facility (the same point as the highway gasoline excise tax). The jet fuel excise tax is imposed on sale of the fuel by a wholesale distributor. Many larger airports have dedicated pipeline facilities that directly service aircraft; in such a case, the tax effectively is imposed at the retail level. The person removing the gasoline from a terminal facility or the wholesale distributor of the jet fuel is liable for these taxes.

Deposit of air transportation excise taxes

Under present law, the air passenger ticket and freight excise taxes are collected from passengers and freight shippers by the commercial air carriers. The air carriers then remit the funds to the Treasury Department; however, the air carriers are not required to remit monies immediately. Excise tax returns are filed quarterly (similar to annual income tax returns) with taxes being deposited on a semi-monthly basis (similar to quarterly estimated income tax deposits). For air transportation sold during a semi-monthly period, air carriers may elect to treat the taxes as collected on the last day of the first week of the second following semi-monthly period. Under these "deemed collected" rules, for example, the taxes on air transportation sold between August 1 and August 15, are treated as collected by the air carriers on or before September 7, with the amounts generally being deposited with the Treasury Department by September 10. A special rule requires certain amounts deemed collected during the second half of September to be deposited by September 29.

Semi-monthly deposits and quarterly excise tax returns also are required with respect to the fuels excise taxes imposed on air transportation.

Overflight user fees

In addition to providing air traffic control and other services for U.S. territorial airspace, the FAA is responsible under international agreements for servicing extensive portions of international airspace over the Atlantic and Pacific Oceans. Non-tax user fees are imposed on air transportation (both commercial and noncommercial aviation) which travels through airspace for which the United States provides air traffic control services, but which neither lands in nor takes off from a point in the United States. These fees are imposed and collected by the FAA with respect to mileage actually flown, and apply both to travel within U.S. territorial airspace and to travel within international oceanic airspace for which the United States is responsible for providing air traffic control services.

Description of Proposal

Extension of Airport and Airway Trust Fund taxes

The Airport and Airway Trust Fund excise taxes, as modified below, would be extended for 10 years, for the period October 1, 1997, through September 30, 2007. The taxes that would be extended include the domestic and international air passenger excise taxes (subject to the modifications described below), the air cargo excise tax, and the noncommercial aviation fuels taxes. Gross receipts from these taxes would continue to be deposited in the Airport and Airway Trust Fund.

Modifications to commercial air passenger transportation taxes

Consolidation of domestic and international air transportation taxes; tax rate.--The current domestic and international air passenger excise taxes would be consolidated into a single excise tax equal to 10 percent of the amount charged for the transportation. In general, all transportation which uses U.S.-controlled airspace and either lands in or takes off from the United States (or both) would be subject to tax. U.S.-controlled airspace would include all airspace within the territorial United States and all international airspace for which the United States has air traffic control responsibility.

International air transportation would be subject to tax on the portion of the travel that takes place within U.S.-controlled airspace. International flights to the United States would be taxed in the same manner as international flights departing the United States. No tax would be imposed on the portion of international flights that takes place outside U.S.-controlled airspace.[58] The total number of miles within U.S.-controlled airspace for a trip involving multiple flight segments would be calculated as the sum of the number of miles in any flight segment that both takes off and lands in the United States, plus the portion of any flight segment between a U.S. airport and a non-U.S. airport that takes place within U.S.-controlled airspace.[59]

For international transportation, the ad valorem portion of the tax would apply to the portion of the total fare charged that equals the percentage of miles traveled within U.S.-controlled airspace as compared to the total miles traveled. For example, if travel between a point in the United States and a point outside the United States were determined to be within U.S.-controlled airspace for the first half of the flight, 50 percent of the amount charged for the transportation would be subject to the ad valorem rate.

In general, this mileage calculation would be identical to that which is used by frequent flyer programs offered by all major U.S. airlines today. Computer programs are readily available for calculating "Great Circle" miles between origin and destination points for flights. The Treasury Department, in consultation with the Departments of Transportation and Commerce, would be required to determine and publish for each "city pair" the percentage of flight miles which occur within U.S.-controlled airspace. In the case of transportation involving multiple flight segments, the Great Circle miles would be determined separately for each flight segment.

Special rules applicable to certain transportation.--Transportation between the 48 contiguous States and Alaska or Hawaii (or between those States) would remain subject to the special rules provided in present law. Thus, this transportation would be taxed on apportioned mileage in U.S. territorial airspace (not U.S.-controlled airspace) plus $6 per one-way flight. Additionally, the current special provisions governing transportation between the United States and points within the 225-mile zone of Canada or Mexico would be retained, with that

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[58] As under present law, flights that both take off from and land at U.S. airports (or within the 225-mile zone, if the transportation is purchased in the United States) are fully taxable as domestic flights, even if a portion of the flight takes place outside U.S.-controlled airspace.

[59] Mileage would be based upon "Great Circle" miles unless another method of measuring mileage (such as predominate routed mileage) is developed by the Treasury Department. The Great Circle miles in a flight segment are based on the shortest distance (i.e., "as the crow flies") between the origination and destination airports.

transportation being taxed on the same basis as other domestic transportation in the circumstances provided under present law.

A further special rule would be provided for certain flight segments to or from qualified rural airports. Under this rule, a qualified rural airport would be any airport that (1) in the second preceding calendar year had fewer than 100,000 commercial passenger enplanements (i.e., departures), and (2) is not located within 75 miles of another airport that had more than 100,000 such passenger enplanements in that year. Flight segments to or from a qualified rural airport would be subject to a reduced, 7.5-percent ad valorem rate (in lieu of the general 10-percent rate).[60] The term flight segment would be defined as transportation involving a single take-off and a single landing. In the case of transportation involving multiple flight segments, the portion of the fare allocable to the rural segment would be determined based on the number of Great Circle miles in the rural flight segment as compared to the aggregate number of miles in all of the flight segments. This is the same calculation that is used in apportioning international transportation between travel in U.S.-controlled airspace and foreign airspace under the proposal and that is used by major U.S. airlines in administering their frequent flyer programs.

Extension of tax to certain currently exempt passengers.--As described above, passengers arriving in the United States from other countries, who currently are the only group of travelers whose transportation is subject neither to an excise tax nor a user fee for U.S.-provided aviation services, would be subject to tax on their arriving international flights. Because all transportation within U.S.-controlled airspace would be subject to tax on the same basis, currently exempt passengers flying domestic flight segments en route to or from international travel would be taxed on those flights.

Clarification further would be provided that any amounts paid to air carriers (in cash or in kind) for the right to award or otherwise distribute free or reduced-rate air transportation would be treated as amounts paid for taxable air transportation, subject to the 10 percent ad valorem tax rate. Examples of such taxable amounts would include (1) payments for frequent flyer miles purchased by credit card companies, telephone companies, rental car companies, television networks, restaurants and hotels, and other businesses for distribution to their customers and others (e.g., employees) and (2) amounts received by airlines pursuant to joint venture credit card or other marketing arrangements. The Treasury Department would be authorized specifically to disregard accounting allocations or other arrangements which have the effect of reducing artificially the base to which the 10-percent tax is applied. (No inference is intended from this provision as to the proper treatment of these payments under present law.)

Liability for tax.--The present-law provision imposing liability for the tax on passengers (with transportation providers being liable only for collecting and remitting revenues to the Federal Government) would be modified to impose secondary liability for payment of the tax on

[60] The Treasury Department would be directed to publish an annual list of qualified rural airports, based on passenger enplanements for the requisite calendar year.

air carriers. As with the current tax, the aggregate tax would continue to be required to be stated separately on passenger tickets.

Modification of air passenger excise tax deposit rules.--The deposit rules with respect to the commercial air passenger excise taxes would be modified to permit payment of those taxes that otherwise would have been required to be deposited during the period August 16, 1997, through September 30, 1997, to be deposited no later October 10, 1997. Similarly, tax deposits that would be due during the period August 1, 2001, through September 30, 2001, would be required to be made no later than October 10, 2001.

Effective Date

These provisions generally would be effective on the date of enactment, for air transportation beginning after September 30, 1997.

Present law requires transportation providers to continue collecting the commercial aviation excise taxes (at the current rates) on transportation to be provided after September 30, 1997, if the transportation is purchased before October 1, 1997. The proposal would require transportation providers to collect the taxes under the modified rules for transportation purchased after the date of enactment for travel beginning after September 30, 1997.

The extension of the general aviation fuels excise taxes would be effective for fuels removed or sold after September 30, 1997.

The provision clarifying application of the commercial air passenger excise tax to certain amounts paid for the right to award air transportation would be effective for amounts paid (or benefits transferred) after September 30, 1997. A special rule would provide that payments (or transfers) between related parties occurring after June 16, 1997, and before October 1, 1997, would be subject to tax if the payments relate to rights to transportation to be awarded or otherwise distributed after September 30, 1997.

The modifications to the commercial air passenger excise tax deposit rules would be effective on the date of enactment.

2. Require gain recognition for certain extraordinary dividends

Present Law

A corporate shareholder generally can deduct at least 70 percent of a dividend received from another corporation. This dividends received deduction is 80 percent if the corporate shareholder owns at least 20 percent of the distributing corporation and generally 100 percent if the shareholder owns at least 80 percent of the distributing corporation.

Section 1059 of the Code requires a corporate shareholder that receives an "extraordinary dividend" to reduce the basis of the stock with respect to which the dividend was received by the nontaxed portion of the dividend. Whether a dividend is "extraordinary" is determined, among other things, by reference to the size of the dividend in relation to the adjusted basis of the shareholder's stock. Also, a dividend resulting from a non pro rata redemption or a partial liquidation is an extraordinary dividend. If the reduction in basis of stock exceeds the basis in the stock with respect to which an extraordinary dividend is received, the excess is taxed as gain on the sale or disposition of such stock, but not until that time (sec. 1059(a)(2)). The reduction in basis for this purpose occurs immediately before any sale or disposition of the stock (sec. 1059(d)(1)(A)). The Treasury Department has general regulatory authority to carry out the purposes of the section.

Except as provided in regulations, the extraordinary dividend provisions do not apply to result in a double reduction in basis in the case of distributions between members of an affiliated group filing consolidated returns, where the dividend is eliminated or excluded under the consolidated return regulations. Double inclusion of earnings and profits (i.e., from both the dividend and from gain on the disposition of stock with a reduced basis) also should generally be prevented.[61] Treasury regulations provide for application of the provision when a corporation is a partner in a partnership that receives a distribution.[62]

In general, a distribution in redemption of stock is treated as a dividend, rather than as a sale of the stock, if it is essentially equivalent to a dividend (sec. 302). A redemption of the stock of a shareholder generally is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. Section 302(b) also contains several specific tests (e.g., a substantial reduction computation and a termination test) to identify redemptions that are not essentially equivalent to dividends. The determination whether a redemption is essentially equivalent to a dividend includes reference to the constructive ownership rules of section 318, including the option attribution rules of section 318(a)(4). The rules relating to treatment of cash or other property received in a reorganization contain a similar reference (sec. 356(a)(2)).

Description of Proposal

Under the proposal, except as provided in regulations, a corporate shareholder would recognize gain immediately with respect to any redemption treated as a dividend (in whole or in part) when the nontaxed portion of the dividend exceeds the basis of the shares surrendered, if the redemption is treated as a dividend due to options being counted as stock ownership.[63]

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[61] See H. Rept. 99-841, II-166, 99th Cong. 2d Sess. (September 18, 1986).

[62] See Treas. reg. sec. 1.701-2(f), Example (2).

[63] Thus, for example, where a portion of such a distribution would not have been treated as a dividend due to insufficient earnings and profits, the rule applies to the portion treated as a

In addition, the proposal would require immediate gain recognition whenever the basis of stock with respect to which any extraordinary dividend was received is reduced below zero. The reduction in basis of stock would be treated as occurring at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction relates.

Reorganizations or other exchanges involving amounts that are treated as dividends under section 356 of the Code are treated as redemptions for purposes of applying the rules relating to redemptions under section 1059(e). For example, if a recapitalization or other transaction that involves a dividend under section 356 has the effect of a non pro rata redemption or is treated as a dividend due to options being counted as stock, the rules of section 1059 apply. Redemptions of shares, or other extraordinary dividends on shares, held by a partnership will be subject to section 1059 to the extent there are corporate partners (e.g., appropriate adjustments to the basis of the shares held by the partnership and to the basis of the corporate partner's partnership interest will be required).

Under continuing section 1059(g) of present law, the Treasury Department would be authorized to issue regulations where necessary to carry out the purposes and prevent the avoidance of the proposal.

Effective Date

The proposal generally would be effective for distributions after May 3, 1995, unless made pursuant to the terms of a written binding contract in effect on May 3, 1995 and at all times thereafter before such distribution, or a tender offer outstanding on May 3, 1995.[64] However, in applying the new gain recognition rules to any distribution that is not a partial liquidation, a non pro rata redemption, or a redemption that is treated as a dividend by reason of options, September 13, 1995 is substituted for May 3, 1995 in applying the transition rules.

No inference is intended regarding the tax treatment under present law of any transaction within the scope of the provision, including transactions utilizing options.

In addition, no inference is intended regarding the rules under present law (or in any case where the treatment is not specified in the provision) for determining the shares of stock with respect to which a dividend is received or that experience a basis reduction.

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dividend.

[64] Thus, for example, in the case of a distribution prior to the effective date, the provisions of present law would continue to apply, including the provisions of present-law sections 1059(a) and 1059(d)(1), requiring reduction in basis immediately before any sale or disposition of the stock, and requiring recognition of gain at the time of such sale or disposition.

3. Require gain recognition on certain distributions of controlled corporation stock

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) as if such property had been sold for its fair market value. The shareholders generally treat the receipt of property as a taxable event as well. Section 355 of the Internal Revenue Code provides an exception to this rule for certain distributions of stock in a controlled corporation, provided that various requirements are met, including certain restrictions relating to acquisitions and dispositions of stock of the distributing corporation ("distributing") or the controlled corporation ("controlled") prior and subsequent to a distribution. Section 358 of the Code provides for allocating a shareholder's pre-distribution basis in stock of distributing between the post-distribution stock of distributing and controlled held by that shareholder. Such allocation is generally based on the respective fair market values of the stock of distributing and controlled.[65]

In cases where the form of the distribution transaction involves a contribution of assets to the particular controlled corporation that is distributed, there are specific Code requirements that distributing corporation's shareholders own "control" of the distributed corporation immediately after the distribution. Control is defined for this purpose as 80 percent of the voting power of all classes of stock entitled to vote and 80 percent of each other class of stock. (Sections 368(a)(1)(D), 368(c) and 351(a) and (c)). In addition, it is a requirement for qualification of any section 355 distribution that the distributing corporation distribute control of the controlled corporation (defined by reference to the same 80-percent test).[66]

Present law has the effect of imposing more restrictive requirements on certain types of acquisitions or other transfers following a distribution if the company involved is the controlled corporation rather than the distributing corporation.

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[65] See, e.g., Treas. Reg. secs. 1.358-1 and 1.358-2.

[66] If a controlled corporation is acquired after a distribution, an issue may arise whether under step-transaction concepts, the acquisition can be viewed as having occurred before the distribution, with the result that the distributing corporation would not be viewed as having distributed the necessary 80 percent control. The Internal Revenue Service has indicated that it will not rule on requests for section 355 treatment in cases in which there have been negotiations, agreements, or arrangements with respect to transactions or events which, if consummated before the distribution, would result in the distribution of stock or securities of a corporation which is not "controlled" by the distributing corporation. Rev. Proc. 96-39, 1996-33 I.R.B. 11; see also Rev. Rul. 96-30, 1996-1 C.B. 36; Rev. Rul. 70-225, 1970-1 C.B. 80.

Description of Proposal

The proposal would adopt additional restrictions under section 355 on acquisitions and dispositions of the stock of distributing and controlled.

Under the proposal, if, pursuant to a plan or arrangement in existence on the date of distribution, either the controlled or distributing corporation is acquired, gain would be recognized by the other corporation as of the date of the distribution.

In the case of an acquisition of a controlled corporation, the amount of gain recognized by the distributing corporation would be the amount of gain that the distributing corporation would have recognized had stock of the controlled corporation been sold for fair market value on the date of distribution. In the case of an acquisition of the distributing corporation, the amount of gain recognized by the controlled corporation would be the amount of net gain that the distributing corporation would have recognized had it sold its assets for fair market value immediately after the distribution. This gain would be treated as long-term capital gain. No adjustment to the basis of the stock or assets of either corporation would be allowed by reason of the recognition of the gain.

Whether a corporation is acquired would be determined under rules similar to those of present law section 355(d), except that acquisitions would not be restricted to "purchase" transactions. Thus, an acquisition would occur if one or more persons acquired 50 percent or more of the vote or value of the stock of the controlled or distributing corporation pursuant to a plan or arrangement. For example, assume a corporation ("P") distributes the stock of its wholly owned subsidiary ("S") to its shareholders. If, pursuant to a plan or arrangement, 50 percent or more of the vote or value of either P or S is acquired by one or more persons, the proposal would require gain recognition by the other corporation. Except as provided in Treasury regulations, if the assets of the distributing or controlled corporation are acquired by a successor in a merger or other transaction under section 368(a)(1)(A), (C) or (D) of the Code, the shareholders (immediately before the acquisition) of the corporation acquiring such assets would be treated as acquiring stock in the corporation from which the assets were acquired. Under Treasury regulations, other asset transfers also could be subject to this rule. However, in any transaction, stock received directly or indirectly by former shareholders of distributing or controlled, in a successor or new controlling corporation of either, would not be treated as acquired stock if it is attributable to such shareholders' stock in distributing or controlled that was not acquired as part of a plan or arrangement to acquire 50 percent or more of such successor or other corporation.

Acquisitions occurring within the four-year period beginning two years before the date of distribution would be presumed to have occurred pursuant to a plan or arrangement. Taxpayers could avoid gain recognition by showing that an acquisition occurring during this four-year period was unrelated to the distribution.

The proposal would not apply to distributions that would otherwise be subject to section 355(d) of present law, which imposes corporate level tax on certain disqualified distributions.

The proposal would not apply to a distribution pursuant to a title 11 or similar case.

The Treasury Department would be authorized to prescribe regulations as necessary to carry out the purposes of the proposal, including regulations to provide for the application of the proposal in the case of multiple transactions.

Except as provided in regulations, in the case of distributions within an affiliated group of corporations (as defined in section 1504(a) and whether or not filing a consolidated return), section 355 would not apply to any distribution within the group that is part of a plan (or series of related transactions) resulting in an acquisition that would be taxable to the distributing or the controlled corporation under the proposal.

In addition, in the case of any section 355 distribution of stock from one member of an affiliated group of corporations (as defined in section 1504(a)) to another, the Treasury Department would be authorized under section 358(c) to provide adjustments to the basis of any stock in a corporation which is a member of such group and is held by another member of such group, to reflect appropriately the proper treatment of such distribution.

The proposal also would modify certain rules for determining control immediately after a distribution in the case of certain divisive transactions in which a controlled corporation is distributed and the transaction meets the requirements of section 355. In such cases, under section 351 and new section 368(a)(2)(H) with respect to reorganizations under section 368(a)(1)(D), those shareholders receiving stock in the distributed corporation would be treated as in control of the distributed corporation immediately after the distribution if they hold stock representing a greater than 50-percent interest in the vote and value of stock of the distributed corporation.

The proposal does not change the present-law requirement under section 355 that the distributing corporation must distribute 80 percent of the voting power and 80 percent of each other class of stock of controlled. It is expected that this requirement will be applied by the Internal Revenue Service taking account of the provisions of the proposal regarding plans that permit certain types of planned restructuring of distributing following the distribution, and to treat similar restructurings of controlled in a similar manner. Thus, the 80-percent control requirement would be expected to be administered in a manner that would prevent the tax-free spin-off of a less-than-80-percent controlled subsidiary, but would not generally impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.

Effective Date

The proposal would generally be effective for distributions after April 16, 1997. However, the part of the proposal providing a greater-than-50-percent control requirement immediately after certain section 351 and 368(a)(1)(D) distributions would be effective for transfers after the date of enactment.

No part of the proposal would apply to a distribution (or transfer, as the case may be) after April 16, 1997, if such distribution or transfer is (1) made pursuant to a written agreement which was binding on such date and at all times thereafter; (2) described in a ruling request submitted to the Internal Revenue Service on or before such date; or (3) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission required solely by reason of the distribution. Any written agreement, ruling request, or public announcement would not be within the scope of these transition provisions unless it identifies the unrelated acquiror of the distributing corporation or of any controlled corporation, whichever is applicable. A distribution from one member of an affiliated group of corporations to another that is an integral part of a distribution that is eligible for transition relief under these rules would not be affected by the provision.

4. Require recognition of gain on certain appreciated positions in personal property

Present Law

Timing of gain or loss

In general, gain or loss is taken into account for tax purposes when realized. Gain or loss generally is realized with respect to a capital asset at the time the asset is sold, exchanged, or otherwise disposed of. Gain or loss is determined by comparing the amount realized with the adjusted basis of the particular property sold. In the case of corporate stock, the basis of shares purchased at different dates or different prices generally is determined by reference to the actual lot sold if it can be identified. Special rules under the Code can defer or accelerate recognition in certain situations.

The recognition of gain or loss is postponed for open transactions. For example, in the case of a "short sale" (i.e., when a taxpayer sells borrowed property such as stock and closes the sale by returning identical property to the lender), no gain or loss on the transaction is recognized until the closing of the borrowing.

Transactions designed to reduce or eliminate risk of loss on financial assets generally do not cause realization. For example, a taxpayer may lock in gain on securities by entering into a "short sale against the box," i.e., when the taxpayer owns securities that are the same as, or substantially identical to, the securities borrowed and sold short. The form of the transaction is respected for income tax purposes and gain on the substantially identical property is not recognized at the time of the short sale. Pursuant to rules that allow specific identification of securities delivered on a sale, the taxpayer can obtain open transaction treatment by identifying the borrowed securities as the securities delivered. When it is time to close out the borrowing, the taxpayer can choose to deliver either the securities held or newly-purchased securities. The Code provides rules only to prevent taxpayers from using short sales against the box to accelerate loss or to convert short-term capital gain into long-term capital gain or long-term capital loss into short-term capital loss (sec. 1233(b)).

Taxpayers also can lock in gain on certain property by entering into offsetting positions in the same or similar property. Under the straddle rules, when a taxpayer realizes a loss on one offsetting position in actively-traded personal property, the taxpayer generally can deduct this loss only to the extent the loss exceeds the unrecognized gain in the other positions in the straddle. In addition, rules similar to the short sale rules prevent taxpayers from changing the tax character of gains and losses recognized on the offsetting positions in a straddle (sec. 1092).

Taxpayers may engage in other arrangements, such as "futures contracts," "forward contracts," "equity swaps" and other "notional principal contracts" where the risk of loss and opportunity for gain with respect to property are shifted to another party (the "counterparty"). These arrangements do not result in the recognition of gain by the taxpayer.

The Code accelerates the recognition of gains and losses in certain cases. For example, taxpayers are required each year to mark to market certain regulated futures contracts, foreign currency contracts, non-equity options, and dealer equity options, and to take any capital gain or loss thereon into account as 40 percent short-term gain and 60 percent long-term gain (sec. 1256).

__Securities dealers__

A dealer in securities must compute its income pursuant to a mark-to-market method of accounting (sec. 475). Any security that is inventory must be included in inventory at its fair market value, and any security that is not inventory and that is held at year end is treated as sold for its fair market value. There is an exception to mark-to-market treatment for any security identified as held for investment or not held for sale to customers (or a hedge of such a security). For this purpose, a "dealer in securities" is a person who (1) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (2) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. For this purpose, "security" means any stock in a corporation; any partnership or beneficial ownership interest in a widely-held or publicly-traded partnership or trust; any note, bond, debenture, or other evidence of indebtedness; an interest rate, currency or equity notional principal contract; any evidence of an interest in, or a derivative financial instrument of any security described above; and certain positions identified as hedges of any of the above. Any gain or loss taken into account under these provisions generally is treated as ordinary gain or loss.

Traders in securities generally are taxpayers who engage in a trade or business involving active sales or exchanges of securities on the market, rather than to customers. The mark-to-market treatment applicable to securities dealers does not apply to traders in securities or to dealers in other property.

__Investment companies__

A contribution of property to a corporation does not result in gain or loss to the contributing shareholder if the contributor is part of a group of contributors who own 80 percent of the voting stock of each class of stock entitled to vote. A contribution of property to a partnership generally does not result in recognition of gain or loss to the contributing partner.

Certain Code sections provide exceptions to the general rule for deferral of pre-contribution gain and loss. Gain or loss is recognized upon a contribution by a shareholder to a corporation that is an investment company (sec. 351(e)(1)). Gain, but not loss, is recognized upon a contribution by a partner to a partnership that would be treated as an investment company if the partnership were a corporation (sec. 721(b)). Under Treasury regulations, a contribution of property by a shareholder to a corporation, or by a partner to a partnership, is treated as a transfer to an investment company only if (1) the contribution results, directly or indirectly, in a diversification of the transferor's interests, and (2) the transferee is (a) a regulated investment company ("RIC"), (b) a real estate investment trust ("REIT"), or (c) a corporation more than 80 percent of the assets of which by value (excluding cash and non-convertible debt instruments) are readily marketable stocks or securities or interests in RICs or REITs that are held for investment (Treas. reg. sec. 1.351-1(c)(1)).

Description of Proposal

The proposal contains provisions that would treat certain transactions involving appreciated financial positions as constructive sales, that would allow securities traders and commodities traders and dealers to elect mark-to-market accounting, and that would expand the definition of an investment company.

Constructive sales

The proposal would require a taxpayer to recognize gain (but not loss) upon entering into a constructive sale of any appreciated position in stock, a partnership interest or certain debt instruments. A taxpayer would be treated as making a constructive sale of an appreciated position when the taxpayer (or, in certain circumstances, a person related to the taxpayer) does one of the following: (1) enters into a short sale of the same property, (2) enters into an offsetting notional principal contract with respect to the same property, or (3) enters into a futures or forward contact to deliver the same property. In addition, for a taxpayer that has entered into a short sale, a notional principal contract or a futures or forward contract, the taxpayer would be treated as making a constructive sale when he acquires property that is the same as the underlying property for the position. A constructive sale under any part of the definition would occur if the two positions were in property that, although not the same, was substantially identical. Finally, to the extent provided in Treasury regulations, a taxpayer would be treated as making a constructive sale when it enters into one or more other transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.

The taxpayer would recognize gain in a constructive sale as if the position were sold at its fair market value on the date of the sale and immediately repurchased. An appropriate adjustment in the basis of the appreciated financial position would be made in the amount of any gain realized under the proposal, and a new holding period of such position would begin as if the taxpayer had acquired the position on the date of the constructive sale.

An appreciated financial position is defined as any position with respect to any stock, debt instrument, or partnership interest, if there would be gain if the position were sold. Certain actively-traded trust instruments would be treated as stock for this purpose. The proposal provides an exception for debt instruments the interest on which is not contingent on profits, the borrower's discretion or similar factors and which are not convertible, directly or indirectly, into stock. A position is defined as any interest, including a futures or forward contract, short sale, or option.

A constructive sale would not include a transaction involving an appreciated financial position that is marked to market, including positions governed by section 475 (mark to market for securities dealers) or section 1256 (mark to market for futures contracts, options and currency contracts).

The proposal would provide an exception from constructive sale treatment for any transaction that is closed before the end of the 30th day after the close of the taxable year in which it was entered into. This exception would not apply, however, where a transaction is closed during the last 60 days of the taxable year or within 30 days thereafter unless (1) the taxpayer holds the appreciated financial position to which the transaction relates (e.g. the stock where the transaction is a short sale) throughout the 60-day period beginning on the date the transaction is closed and (2) at no time during such 60-day period is the taxpayer's risk of loss reduced by holding positions with respect to substantially similar or related property.

A person would be considered related to another for purposes of the proposal if the relationship was one described in section 267 or section 707(b) and the transaction is entered into with a view toward avoiding the purposes of the provision.

If there is a constructive sale of less than all of any type of property held by the taxpayer, the specific property deemed sold would be determined under the rules governing actual sales, after adjusting for previous constructive sales under the proposal.

Extension of mark-to-market treatment by election

The proposal would allow securities traders and commodities traders and dealers to elect application of the mark-to-market accounting rules, which apply only to securities dealers under present law. Securities held by an electing taxpayer in connection with a trade or business as a securities trader or a commodities trader or dealer would be treated as not held for investment under section 475, and thus would generally be subject to mark-to-market treatment. The election would be made separately with respect to each trade or business of the taxpayer, such as a business as a securities trader or a business as a commodities dealer. The election would be effective for the taxable year for which it is made and all subsequent taxable years, unless revoked with the consent of the Secretary of the Treasury. As under present law, gain or loss recognized by an electing taxpayer under the proposal would be ordinary gain or loss, and the taxpayer would be allowed to identify property not held in connection with its trade or business as not subject to the election.

Investment company definition

The proposal would modify the definition of an investment company for purposes of determining whether a transfer of property to a partnership or corporation results in gain recognition (secs. 351(e) and 721(b)) by requiring that certain assets be taken into account for purposes of the definition, in addition to marketable stock and securities as under present law.

Under the proposal, an investment company would include a RIC or REIT as under present law. In addition, an investment company would include any corporation or partnership if more than 80 percent of its assets by value consist of money, financial instruments, foreign currency, interests in REITs, RICs, common trust funds and publicly-traded partnerships, and certain interests in precious metals and entities that hold the above-listed items.[67] The proposal grants regulatory authority to the Treasury to add other assets to the list set out in the provision.

Effective Date

The provision would be effective for constructive sales entered into after June 8, 1997. A special rule would be provided for transactions before this date which would have been constructive sales under the provision. The positions in such a transaction would not be taken into account in determining whether a constructive sale after June 8, 1997, occurs, provided that the taxpayer identifies the offsetting positions of the earlier transaction within 30 days after the date of enactment. The special rule would cease to apply on the date the taxpayer ceased to hold any of the positions so identified.

In the case of a decedent dying after June 8, 1997, if (1) a constructive sale of an appreciated financial position (as defined in the proposal) occurs before such date, (2) the transaction remains open for not less than two years, and (3) the transaction is not closed in a taxable transaction within 30 days after the date of enactment, such position (and any property related to it, under principles of the provision) will be treated as property constituting rights to receive income in respect of a decedent under section 691.

The mark-to-market accounting election would apply to taxable years of traders and dealers ending after the date of enactment. For a taxpayer making the election, the adjustments required under section 481 as a result of the change in accounting method are required to be taken into account ratably over a four-year period.

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[67] Where assets are defined by reference to provisions of section 731(c)(2), it is intended that the Treasury regulations promulgated under those provisions will also be applicable.

The change in the definition of an investment company would apply to all transfers after June 8, 1997, in taxable years ending after such date. An exception is provided for transfers of a fixed amount of securities made pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter until the transfer.

5. Modify net operating loss carryback and carryforward rules

Present Law

The net operating loss ("NOL") of a taxpayer (generally, the amount by which the business deductions of a taxpayer exceeds its gross income) may be carried back three years and carried forward 15 years to offset taxable income in such years. A taxpayer may elect to forgo the carryback of an NOL. Special rules apply to real estate investment trusts ("REITs") (no carrybacks), specified liability losses (10-year carryback), and excess interest losses (no carrybacks).

Description of Proposal

The proposal would limit the NOL carryback period to two years and extend the NOL carryforward period to 20 years. The proposal would not apply to the carryback rules relating to REITs, specified liability losses, excess interest losses, and corporate capital losses. In addition, the proposal would not apply to NOLs arising from casualty losses of individual taxpayers.

Effective Date

The proposal would be effective for NOLs arising in taxable years beginning after the date of enactment.

6. Modify foreign tax credit carryover rules

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. Separate foreign tax credit limitations are applied to specific categories of income.

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and forward five years. The amount carried over may be used as a credit in a carryover year to the extent the taxpayer otherwise has excess foreign tax credit limitation for such year. The separate foreign tax credit limitations apply for purposes of the carryover rules.

Description of Proposal

The proposal would reduce the carryback period for excess foreign tax credits from two years to one year. The proposal also would extend the excess foreign tax credit carryforward period from five years to seven years.

Effective Date

The proposal would apply to foreign tax credits arising in taxable years beginning after December 31, 1997.

7. Modify holding period for dividends-received deduction

Present Law

If an instrument issued by a U.S. corporation is classified for tax purposes as stock, a corporate holder of the instrument generally is entitled to a dividends received deduction for dividends received on that instrument. This deduction is 70 percent of dividends received if the recipient owns less than 20 percent (by vote and value) of stock of the payor. If the recipient owns more than 20 percent of the stock the deduction is increased to 80 percent. If the recipient owns more than 80 percent of the payor's stock, the deduction is further increased to 100 percent for qualifying dividends.

The dividends-received deduction is allowed to a corporate shareholder only if the shareholder satisfies a 46-day holding period for the dividend-paying stock (or a 91-day period for certain dividends on preferred stock). The 46- or 91-day holding period generally does not include any time in which the shareholder is protected from the risk of loss otherwise inherent in the ownership of an equity interest. The holding period must be satisfied only once, rather than with respect to each dividend received.

Description of Proposal

The proposal would provide that a taxpayer is not entitled to a dividends-received deduction if the taxpayer's holding period for the dividend-paying stock is not satisfied over a period immediately before or immediately after the taxpayer becomes entitled to receive the dividend.

Effective Date

The proposal would be effective for dividends paid or accrued after the 30th day after the date of the enactment of the provision.

8. Inclusion of income from notional principal contracts and stock lending transactions under subpart F

Present Law

Under the subpart F rules, the U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, "foreign personal holding company income."

Foreign personal holding company income generally consists of the following: dividends, interest, royalties, rents and annuities; net gains from sales or exchanges of (1) property that gives rise to the foregoing types of income, (2) property that does not give rise to income, and (3) interests in trusts, partnerships, and REMICs; net gains from commodities transactions; net gains from foreign currency transactions; and income that is equivalent to interest. Income from notional principal contracts referenced to commodities, foreign currency, interest rates, or indices thereon is treated as foreign personal holding company income; income from equity swaps or other types of notional principal contracts is not treated as foreign personal holding company income. Income derived from transfers of debt securities (but not equity securities) pursuant to the rules governing securities lending transactions (sec. 1058) is treated as foreign personal holding company income.

Income earned by a CFC that is a regular dealer in the property sold or exchanged generally is excluded from the definition of foreign personal holding company income. However, no exception is available for a CFC that is a regular dealer in financial instruments referenced to commodities.

A U.S. shareholder of a passive foreign investment company ("PFIC") is subject to U.S. tax and an interest charge with respect to certain distributions from the PFIC and gains on dispositions of the stock of the PFIC, unless the shareholder elects to include in income currently for U.S. tax purposes its share of the earnings of the PFIC. A foreign corporation is a PFIC if it satisfies either a passive income test or a passive assets test. For this purpose, passive income is defined by reference to foreign personal holding company income.

Description of Proposal

The proposal would treat net income from all types of notional principal contracts as a new category of foreign personal holding company income. However, income, gain, deduction or loss from a notional principal contract entered into to hedge an item of income in another category of foreign personal holding company income would be included in that other category.

The proposal would treat payments in lieu of dividends derived from equity securities lending transactions pursuant to section 1058 as another new category of foreign personal holding company income.

The proposal would provide an exception from foreign personal holding company income for certain income, gain, deduction, or loss from transactions (including hedging transactions) entered into in the ordinary course of a CFC's business as a regular dealer in property, forward contracts, options, notional principal contracts, or similar financial instruments (including instruments referenced to commodities).

These modifications to the definition of foreign personal holding company income would apply for purposes of determining a foreign corporation's status as a PFIC.

Effective Date

The proposal would apply to taxable years beginning after the date of enactment.

9. Restrict like-kind exchange rules for certain personal property

Present Law

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in trade or business or for investment is exchanged for property of a "like-kind" which is to be held for productive use in trade or business or for investment (sec. 1031). In general, any kind of real estate is treated as of a like-kind with other real property as long as the properties are both located either within or outside the United States. Different types of personal property are not treated as like-kind unless such properties are of a "like class." In addition, certain types of property, such as inventory, stocks and bonds, and partnership interests, are not eligible for nonrecognition treatment under section 1031.

If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred, decreased by any money received by the taxpayer, and further adjusted for any gain or loss recognized on the exchange.

Description of Proposal

The proposal would provide that personal property located in the United States and personal property located outside the United States are not "like-kind" properties. For this purpose, the location of the properties would be determined at the time of the exchange. In addition, the property surrendered in the exchange must have been used during the 24 months immediately prior to the exchange in predominantly the same use (i.e., foreign or domestic) as at the time of the exchange. Similarly, for section 1031 to apply, property received in the exchange must continue in the same use (i.e., foreign or domestic) for the 24 months immediately after the exchange.

Effective Date

The proposal would be effective for exchanges after June 8, 1997, unless the exchange is pursuant to a binding contract in effect on such date and all times thereafter. A contract would not fail to be considered to be binding solely because (1) it provides for a sale in lieu of an exchange or (2) either the property to be disposed of as relinquished property or the property to be acquired as replacement property (whichever is applicable) was not identified under the contract before June 9, 1997.

10. Reinstate Leaking Underground Storage Tank Trust Fund excise tax

Present Law

Before January 1, 1996, an excise tax of 0.1 cent per gallon was imposed on gasoline, diesel fuel (including train diesel fuel), special motor fuels (other than liquefied petroleum gas), aviation fuels, and inland waterways fuels. Revenues from the tax were dedicated to the Leaking Underground Storage Tank Trust Fund to finance cleanups of leaking underground storage tanks.

Description of Proposal

The proposal would reinstate the prior-law Leaking Underground Storage Tank Trust Fund excise tax through September 30, 2007.

Effective Date

The provision would be effective on the date of enactment.

11. Treat certain preferred stock as "boot"

Present Law

In reorganization transactions within the meaning of section 368 and certain other restructurings, no gain or loss is recognized except to the extent "other property" (often called "boot") is received, that is, property other than certain stock, including preferred stock. Thus, preferred stock can be received tax-free in a reorganization, notwithstanding that many preferred stocks are functionally equivalent to debt securities. Upon the receipt of "other property," gain but not loss can be recognized. A special rule permits debt securities to be received tax-free, but only to the extent debt securities of no lesser principal amount are surrendered in the exchange. Other than this debt-for-debt rule, similar rules generally apply to transactions described in section 351.

Description of Proposal

The proposal would amend the relevant provisions (secs. 351, 354, 355, 356 and 1036) to treat certain preferred stock as "other property" (i.e., "boot") subject to certain exceptions. Thus, when a taxpayer exchanges property for this preferred stock in a transaction that qualifies under either section 351 or section 368, gain but not loss would be recognized.

The proposal would apply to preferred stock (i.e., stock that is limited and preferred as to dividends and does not participate, including through a conversion privilege, in corporate growth to any significant extent), where (1) the holder has the right to require the issuer or a related person (within the meaning of secs. 267(b) and 707(b)) to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase the stock, (3) the issuer (or a related person) has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices, regardless of whether such varying rate is provided as an express term of the stock (for example, in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (for example, in the case of auction rate stock). For this purpose, the rules of (1), (2), and (3) would apply if the right or obligation may be exercised within 20 years of the date the instrument is issued and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase. In addition, if neither the stock surrendered nor the stock received in the exchange is stock of a corporation any class of stock of which (or of a related corporation) is publicly traded, a right or obligation would be disregarded if it may be exercised only upon the death, disability, or mental incompetency of the holder. Also, a right or obligation would be disregarded in the case of stock transferred in connection with the performance of services if it may be exercised only upon the holder's separation from service.

The following exchanges would be excluded from this gain recognition: (1) certain exchanges of preferred stock for comparable preferred stock of the same or lesser value; (2) an exchange of preferred stock for common stock; (3) certain exchanges of debt securities for preferred stock of the same or lesser value; and (4) exchanges of stock in certain recapitalizations of family-owned corporations. For this purpose, a family-owned corporation would be defined as any corporation if at least 50 percent of the total voting power and value of the stock of such corporation is owned by members of the same family for five years preceding the recapitalization. In addition, a recapitalization does not qualify for the exception if the same family does not own 50 percent of the total voting power and value of the stock throughout the three-year period following the recapitalization. Members of the same family would be defined by reference to the definition in section 447(e). Thus, a family would include children, parents, brothers, sisters, and spouses, with a limited attribution for directly and indirectly owned stock of the corporation. Shares held by a family member would be treated as not held by a family member to the extent a non-family member had a right, option or agreement to acquire the shares (directly or indirectly, for example, through redemptions by the issuer), or with respect to shares as to which a family member has reduced its risk of loss with respect to the share, for example, through an equity swap. Even though the provision excepts certain family recapitalizations, the special valuation rules of section 2701 for estate and gift tax consequences would continue to apply.

An exchange of nonqualified preferred stock for nonqualified preferred stock in an acquiring corporation may qualify for tax-free treatment under section 354, but not section 351. In cases in which both sections 354 and 351 may apply to a transaction, section 354 generally will apply for purposes of this proposal. Thus, in that situation, the exchange would be tax free.

The Treasury Secretary would have regulatory authority to (1) apply installment sale-type rules to preferred stock that is subject to this proposal in appropriate cases and (2) prescribe treatment of preferred stock subject to this provision under other provisions of the Code (e.g., secs. 304, 306, 318, and 368(c)). Until regulations are issued, preferred stock that is subject to the proposal shall continue to be treated as stock under other provisions of the Code.

Effective Date

The proposal would be effective for transactions after June 8, 1997, but would not apply to such transactions (1) made pursuant to a written agreement which was binding on such date and at all times thereafter, (2) described in a ruling request submitted to the Internal Revenue Service on or before such date, or (3) described in a public announcement or filing with the Securities and Exchange Commission on or before such date.

12. Extension of Federal unemployment surtax

Present Law

The Federal Unemployment Tax Act (FUTA) imposes a 6.2-percent gross tax rate on the first $7,000 paid annually by covered employers to each employee. Employers in States with programs approved by the Federal Government and with no delinquent Federal loans may credit 5.4-percentage points against the 6.2-percent tax rate, making the minimum, net Federal unemployment tax rate 0.8 percent. Since all States have approved programs, 0.8 percent is the Federal tax rate that generally applies. This Federal revenue finances administration of the system, half of the Federal-State extended benefits program, and a Federal account for State loans. The States use the revenue turned back to them by the 5.4 percent credit to finance their regular State programs and half of the Federal-State extended benefits program.

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8 percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent. The temporary surtax has been subsequently extended through 1998.

Description of Proposal

The proposal would extend the temporary surtax rate through December 31, 2007. The proposal would also increase the limit from .25% to .50% of covered wages on the Federal Unemployment Account (FUA) in the Unemployment Trust Fund

Effective Date

The proposal would be effective for labor performed on or after January 1, 1999.

13. Modify the exception to the related party rule of section 1033 for individuals to only provide an exception for de minimis amounts

Present Law

Under section 1033, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified period of time. Pursuant to a provision of Public Law 104-7, subchapter C corporations (and certain partnerships with corporate partners) are not entitled to defer gain under section 1033 if the replacement property or stock is purchased from a related person. A person is treated as related to another person if the person bears a relationship to the other person described in section 267(b) or 707(b)(1). An exception to this related party rule provides that a taxpayer could purchase replacement property or stock from a related person and defer gain under section 1033 to the extent the related person acquired the replacement property or stock from an unrelated person within the period prescribed under section 1033.

Description of Proposal

The proposal would expand the present-law denial of the application of section 1033 to any other taxpayer (including an individual) that acquires replacement property from a related party (as defined by secs. 267(b) and 707(b)(1)) unless the taxpayer has aggregate realized gain of $100,000 or less for the taxable year with respect to converted property with aggregate realized gains. In the case of a partnerships (or S corporation), the annual $100,000 limitation would apply to both the partnership (or S corporation) and each partner (or shareholder).

Effective Date

The proposal applies to involuntary conversions occurring after June 8, 1997.

14. Registration of confidential corporate tax shelters and substantial understatement penalty

Present Law

Tax shelter registration

An organizer of a tax shelter is required to register the shelter with the Internal Revenue Service (IRS) (sec. 6111). If the principal organizer does not do so, the duty may fall upon any other participant in the organization of the shelter or any person participating in its sale or management. The shelter's identification number must be furnished to each investor who purchases or acquires an interest in the shelter. Failure to furnish this number to the tax shelter investors will subject the organizer to a $100 penalty for each such failure (sec. 6707(b)).

A penalty may be imposed against an organizer who fails without reasonable cause to timely register the shelter or who provides false or incomplete information with respect to it. The penalty is the greater of one percent of the aggregate amount invested in the shelter or $500. Any person claiming any tax benefit with respect to a shelter must report its registration number on her return. Failure to do so without reasonable cause will subject that person to a $250 penalty (sec. 6707(b)(2)).

A person who organizes or sells an interest in a tax shelter subject to the registration rule or in any other potentially abusive plan or arrangement must maintain a list of the investors (sec. 6112). A $50 penalty may be assessed for each name omitted from the list. The maximum penalty per year is $100,000 (sec. 6708).

For this purpose, a tax shelter is defined as any investment that meets two requirements. First, the investment must be (1) required to be registered under a Federal or state law regulating securities, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or state agency regulating the offering or sale of securities, or (3) a substantial investment. Second, it must be reasonable to infer that the ratio of deductions and 350 percent of credits to investment for any investor (i.e., the tax shelter ratio) may be greater than two to one as of the close of any of the first five years ending after the date on which the investment is offered for sale. An investment that meets these requirements will be considered a tax shelter regardless of whether it is marketed or customarily designated as a tax shelter (sec. 6111(c)(1)).

__Substantial understatement penalty__

The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement.

The substantial understatement penalty applies in the following manner. If the correct income tax liability of a taxpayer for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return and there was a reasonable basis for the tax treatment of the item. Special rules apply to tax shelters.

With respect to tax shelter items of non-corporate taxpayers, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for his position, he reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters. The reduction in the understatement for items disclosed on the return is inapplicable to both corporate and non-corporate tax shelters. For this purpose, a tax shelter is a partnership or other entity, plan, or arrangement the principal purpose of which is the avoidance or evasion of Federal income tax.

The Secretary may waive the penalty with respect to any item if the taxpayer establishes reasonable cause for his treatment of the item and that he acted in good faith.

Description of Proposal

Tax shelter registration

The proposal would require a promoter of a corporate tax shelter to register the shelter with the Secretary. Registration would be required not later than the next business day after the day when the tax shelter is first offered to potential users. If the promoter is not a U.S. person, or if a required registration is not otherwise made, then any U.S. participant would be required to register the shelter. An exception to this special rule provides that registration would not be required if the U.S. participant notifies the promoter in writing not later than 90 days after discussions began that the U.S. participant will not participate in the shelter and the U.S. person does not in fact participate in the shelter.

A corporate tax shelter is any investment, plan, arrangement or transaction (1) a significant purpose of the structure of which is tax avoidance or evasion by a corporate participant, (2) that is offered to any potential participant under conditions of confidentiality, and (3) for which the tax shelter promoters may receive total fees in excess of $100,000.

A transaction is offered under conditions of confidentiality if: (1) an offeree (or any person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to restrict or limit its disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows or has reason to know (or the promoter causes another person to claim or otherwise knows or has reason to know that a party other than the potential offeree claims) that the transaction (or one or more aspects of its structure) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use. The promoter includes specified related parties.

Registration will require the submission of information identifying and describing the tax shelter and the tax benefits of the tax shelter, as well as such other information as the Treasury Department may require.

Tax shelter promoters are required to maintain lists of those who have signed confidentiality agreements, or otherwise have been subjected to nondisclosure requirements, with respect to particular tax shelters. In addition, promoters must retain lists of those paying fees with respect to plans or arrangements that have previously been registered (even though the particular party may not have been subject to confidentiality restrictions).

All registrations will be treated as taxpayer information under the provisions of section 6103 and will therefore not be subject to any public disclosure.

The penalty for failing to timely register a corporate tax shelter is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration (i.e., this part of the penalty does not apply to fee payments with respect to offerings after late registration). A similar penalty is applicable to actual participants in any corporate tax shelter who were required to register the tax shelter but did not. With respect to participants, however, the 50-percent penalty is based only on fees paid by that participant. Intentional disregard of the requirement to register by either a promoter or a participant increases the 50-percent penalty to 75 percent of the applicable fees.

Substantial understatement penalty

The proposal would make two modifications to the substantial understatement penalty. The first modification would affect the reduction in the amount of the understatement which is attributable to an item if there is a reasonable basis for the treatment of the item. The proposal would provide that in no event would a corporation have a reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction if such treatment does not clearly reflect the income of the corporation. No inference is intended that such a multi-party financing transaction could not also be a tax-shelter as defined under the modification described below or under current law.

The second modification would affect the special tax shelter rules, which define a tax shelter as an entity the principal purpose of which is the avoidance or evasion of Federal income tax. The proposal would instead provide that a significant purpose (rather than the principal purpose) of the entity must be the avoidance or evasion of Federal income tax for the entity to be considered a tax shelter. This modification would conform the definition of tax shelter for purposes of the substantial understatement penalty to the definition of tax shelter for purposes of these new confidential corporate tax shelter registration requirements.

Treasury report

The proposal would also direct the Treasury Department, in consultation with the Department of Justice, to issue a report to the tax-writing committees on the following tax shelter issues: (1) a description of enforcement efforts under section 7408 of the Code (relating to actions to enjoin promoters of abusive tax shelters) with respect to corporate tax shelters and the lawyers, accountants, and others who provide opinions (whether or not directly addressed to the taxpayer) regarding aspects of corporate tax shelters; (2) an evaluation of whether the penalties regarding corporate tax shelters are generally sufficient; and (3) an evaluation of whether confidential tax shelter registration should be extended to transactions where the investor (or potential investor) is not a corporation. The report would be due one year after the date of enactment.

Effective Date

The tax shelter registration proposal would apply to any tax shelter offered to potential participants after the date the Treasury Department issues guidance with respect to the filing requirements. The modifications to the substantial understatement penalty would apply to items with respect to transactions entered into after the date of enactment.

15. Information reporting on persons receiving contract payments from certain Federal agencies

Present Law

A service recipient (i.e., a person for whom services are performed) engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must file with the IRS an information return reporting such payments (and the name, address, and taxpayer identification number of the recipient) if the remuneration paid to the person during the calendar year is $600 or more (sec. 6041A(a)). A similar statement must also be furnished to the person to whom such payments were made (sec. 6041A(e)). Treasury regulations explicitly exempt from this reporting requirement payments made to a corporation (Treas. reg. sec. 1.6041A-1(d)(2)).

The head of each Federal executive agency must file an information return indicating the name, address, and taxpayer identification number (TIN) of each person (including corporations) with which the agency enters into a contract (sec. 6050M). The Secretary of the Treasury has the authority to require that the returns be in such form and be made at such time as is necessary to make the returns useful as a source of information for collection purposes. The Secretary is given the authority both to establish minimum amounts for which no reporting is necessary as well as to extend the reporting requirements to Federal license grantors and subcontractors of Federal contracts. Treasury regulations provide that no reporting is required if the contract is for $25,000 or less (Treas. reg. sec. 1.6050M-1(c)(1)(i)).

Description of Proposal

The proposal would require reporting of all payments of $600 or more made by a Federal executive agency to any person (including a corporation) for services. In addition, the proposal would require that a copy of the information return be sent by the Federal agency to the recipient of the payment. An exception would be provided for certain classified or confidential contracts.

Effective Date

The proposal would be effective for returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment.

16. Disclosure of tax return information for administration of certain veterans programs

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service ("IRS") to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Among the disclosures permitted under the Code is disclosure to the Department of Veterans Affairs ("DVA") of self-employment tax information and certain tax information supplied to the Internal Revenue Service and Social Security Administration by third parties. Disclosure is permitted to assist DVA in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension, health care, and other programs (sec. 6103(1)(7)(D)(viii)). The income tax returns filed by the veterans themselves are not disclosed to DVA.

The DVA is required to comply with the safeguards currently contained in the Code and in section 1137(c) of the Social Security Act (governing the use of disclosed tax information). These safeguards include independent verification of tax data, notification to the individual concerned, and the opportunity to contest agency findings based on such information.

The DVA disclosure provision is scheduled to expire after September 30, 1998.

Description of Proposal

The proposal would permanently extend the DVA disclosure provision.

Effective Date

The proposal would be effective on the date of enactment.

17. Holding period for certain foreign tax credits

Present Law

A U.S. person that receives a dividend from a foreign corporation generally is entitled to a credit for income taxes paid to a foreign government on the dividend, regardless of the U.S. person's holding period for the foreign corporation's stock. A U.S. corporation that receives a dividend from a foreign corporation in which it has a 10-percent or greater voting interest may be entitled to a credit for the foreign taxes paid by the foreign corporation, also without regard to the U.S. shareholder's holding period for the corporation's stock (sections 902 and 960).

As a consequence of the foreign tax credit limitations of the Code, certain taxpayers are unable to utilize their creditable foreign taxes to reduce their U.S. tax liability. U.S. shareholders that are tax-exempt receive no U.S. tax benefit for foreign taxes paid on dividends they receive.

Description of Proposal

The proposal would deny a shareholder the foreign tax credits normally available with respect to a dividend from a corporation or a regulated investment company ("RIC") if the shareholder has not held the stock for a minimum period during which it is not protected from risk of loss. Under the proposal, the minimum holding period for dividends on common stock is 16 days. The minimum holding period for preferred stock is 46 days.

Where the holding period requirement is not met for stock of a foreign corporation, the proposal would disallow the foreign tax credits for the foreign withholding taxes that are paid with respect to a dividend. In addition, the proposal would apply to all foreign tax credits otherwise allowable for taxes paid by a lower-tier foreign corporation (secs. 902 and 960) and for foreign tax credits of a RIC that elects to treat its foreign taxes as paid by the shareholders (section 853). The proposal would deny such credits where any of the stock in the chain of ownership that is a requirement for claiming the credits is held for less than the required holding period.

The proposal would deny these same foreign tax credit benefits, regardless of the shareholder's holding period for the stock, to the extent that the taxpayer has an obligation to make payments related to the dividend (whether pursuant to a short sale or otherwise) with respect to substantially similar or related property.

The 16- or 46-day holding period under the proposal (whichever applies) would be required to be satisfied over a period immediately before or immediately after the shareholder becomes entitled to receive each dividend. For purposes of determining whether the required holding period is met, any period during which the shareholder has protected itself from risk of loss (under the rules of section 246(c)(4)) would not be included. For example, assume a taxpayer buys foreign common stock. Assume also that, the day after the stock is purchased, the taxpayer enters into an equity swap under which the taxpayer is entitled to receive payments equal to the losses on the stock, and the taxpayer retains the swap position for the entire period that it holds the stock. Under the proposal, the taxpayer would not be able to claim any foreign tax credits with respect to dividends on the stock because the taxpayer's holding period is limited to the single day during which the loss on the stock was not protected. For purposes of entitlement to indirect foreign tax credits, the proposal would provide an exception from the risk reduction rule for a bona fide contract to sell stock.

The proposal would also provide an exception for foreign tax credits with respect to certain dividends received by active dealers in securities. In order to qualify for the exception, the following requirements would have to be met: (1) the dividend must be received by the entity on stock which it holds in its capacity as a dealer in securities, (2) the entity must be subject to net income taxation on the dividend (on either a residence or worldwide income basis) in a foreign country, and (3) the foreign taxes to which the exception applies must be taxes that are creditable under the foreign county's tax system. A securities dealer for purposes of the exception must be an entity which (1) is engaged in the active conduct of a securities business in a foreign country and (2) is registered as a securities broker or dealer under the Securities Exchange Act of 1934 or is licenced or authorized to conduct securities activities in such foreign county and subject to bona fide regulation by the securities regulatory authority of the foreign country. Under the proposal, the Secretary of the Treasury is granted authority to issue regulations appropriate to prevent abuse of this exception.

If a taxpayer is denied foreign tax credits under the proposal because the 16- or 46-day holding period requirement is not satisfied, the taxpayer would be entitled to a deduction for the foreign taxes for which the credit is disallowed. This deduction would be available even if the taxpayer claimed the foreign tax credit for other taxes in the same taxable year.

Effective Date

The provision would be effective for dividends paid or accrued more than 30 days after the date of enactment.

18. Reform tax treatment of certain corporate stock transfers

Present Law

Under section 304, if one corporation purchases stock of a related corporation, the transaction generally is recharacterized as a redemption. In determining whether a transaction so recharacterized is treated as a sale or a dividend, reference is made to the changes in the selling corporation's ownership of stock in the issuing corporation (applying the constructive ownership rules of section 318(a) with modifications under section 304(c)). Sales proceeds received by a corporate transferor that are characterized as a dividend may qualify for the dividends received deduction under section 243, and such dividend may bring with it foreign tax credits under section 902. Section 304 does not apply to transfers of stock between members of a consolidated group.

Section 1059 applies to "extraordinary dividends," including certain redemption transactions treated as dividends qualifying for the dividends received deduction. If a redemption results in an extraordinary dividend, section 1059 generally requires the shareholder to reduce its basis in the stock of the redeeming corporation by the nontaxed portion of such dividend.

Description of Proposal

Under the proposal, to the extent that a section 304 transaction is treated as a distribution under section 301, the transferor and the acquiring corporation would be treated as if (1) the transferor had transferred the stock involved in the transaction to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation had then redeemed the stock it is treated as having issued. Thus, the acquiring corporation would be treated for all purposes as having redeemed the stock it is treated as having issued to the transferor. In addition, the proposal would amend section 1059 so that, if the section 304 transaction is treated as a dividend to which the dividends received deduction applies, the dividend would be treated as an extraordinary dividend in which only the basis of the transferred shares would be taken into account under section 1059.

Under the proposal, a special rule would apply to section 304 transactions involving acquisitions by foreign corporations. The proposal would limit the earnings and profits of the acquiring foreign corporation that would be taken into account in applying section 304. The earnings and profits of the acquiring foreign corporation to be taken into account would not exceed the portion of such earnings and profits that (1) is attributable to stock of such acquiring corporation held by a corporation or individual who is the transferor (or a person related thereto) and who is a U.S. shareholder (within the meaning of sec. 951(b)) of such corporation, and (2) was accumulated during periods in which such stock was owned by such person while such acquiring corporation was a controlled foreign corporation. For purposes of this rule, except as otherwise provided by the Secretary of the Treasury, the rules of section 1248(d) (relating to certain exclusions from earnings and profits) would apply. The Secretary of the Treasury would prescribe regulations as appropriate, including regulations determining the earnings and profits that are attributable to particular stock of the acquiring corporation.

No inference is intended as to the treatment of any transaction under present law.

Effective Date

The proposal would be effective for distributions or acquisitions after June 8, 1997 except that the proposal would not apply to any such distribution or acquisition (1) made pursuant to a written agreement which was binding on such date and at all times thereafter, (2) described in a ruling request submitted to the Internal Revenue Service on or before such date, or (3) described in a public announcement or filing with the Securities and Exchange Commission on or before such date.

19. Eligibility for income forecast method

Present Law

In general

A taxpayer generally recovers the cost of property used in a trade or business through depreciation or amortization deductions over time. Tangible property generally is depreciated under the modified Accelerated Cost Recovery System ("MACRS") of section 168, which applies specific recovery periods and depreciation methods to the cost of various types of depreciable property. Intangible property generally is amortized under section 197, which applies a 15-year recovery period and the straight-line method to the cost of applicable property.

Treatment of film, video tape, and similar property

MACRS does not apply to certain property, including any motion picture film, video tape, or sound recording or to other any property if the taxpayer elects to exclude such property from MACRS and the taxpayer applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be recovered under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost of such property may be depreciated under the "income forecast" method.

Under the income forecast method, the depreciation deduction for a taxable year for a property is determined by multiplying the cost of the property (less estimated salvage value) by a fraction, the numerator of which is the income generated by the property during the year and the denominator of which is the total forecasted or estimated income to be derived from the property during its useful life. The income forecast method has been held to be applicable for computing depreciation deductions for motion picture films, television films and taped shows, books, patents, master sound recordings and video games. [68] Most recently, the income forecast method has been held applicable to consumer durable property subject to short-term "rent-to-own" leases.[69]

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[68] See, e.g., Rev. Rul. 60-358, 1960-2 C.B. 68; Rev. Rul. 64-273, 1964-2 C.B. 62; Rev. Rul 79-285, 1979-2 C.B. 91; and Rev. Rul. 89-62, 1989-1 C.B. 78. Conversely, the courts have held that certain tangible personal property was not of a character to which the income forecast method was applicable.

[69] See, ABC Rentals of San Antonio v. Comm., No. 95-9008 (10th Cir. 9/27/96), the Tenth Circuit decision reversed the holding of ABC Rentals of San Antonio v. Comm., 68 TCM

Description of Proposal

The proposal would clarify the types of property to which the income forecast method may be applied. Under the proposal, the income forecast method would be applicable to motion picture films, television films and taped shows, books, patents, master sound recordings, copyrights, and other such property as designated by the Secretary of the Treasury. The income forecast method would not be applicable to property to which section 197 applies.

In addition, consumer durables subject to rent-to-own contracts would be provided a three-year recovery period and a 4- year class life for MACRS purposes (and would not be eligible for the income forecast method). Such property generally is described in Rev. Proc. 95-38, 1995-34 I.R.B. 25.

Effective Date

The proposal would be effective for property placed in service after the date of enactment.

20. Gains and losses from certain terminations with respect to property

Present Law

Extinguishment treated as sale or exchange.--The definition of capital gains and losses in section 1222 requires that there be a "sale or exchange" of a capital asset. Court decisions interpreted this requirement to mean that when a disposition is not a sale or exchange of a capital asset, for example, a lapse, cancellation, or abandonment, the disposition produces ordinary income or loss.[70] Under a special provision, gains and losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to certain personal property are treated as gains or losses from the sale of a capital asset (sec. 1234A). Personal property subject to this rule is (1) personal property (other than stock that is not part of straddle or of a corporation that is not formed or availed of to take positions which offset positions in personal property of its shareholders) of a type which is actively traded and which is, or would be on acquisition, a capital asset in the hands of the taxpayer and (2) a "section 1256 contract"[71] which is

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1362 (1994) (consumer durable property subject to short-term, "rent-to-own" leases not eligible). For decisions supporting the Tax Court decision, see, El Charro TV Rental v. Comm., No. 95-60301 (5th Cir., May 16, 1995) (rent-to-own property not eligible) and Carland, Inc. v. Comm., 90 T.C. 505 (1988), aff'd on this issue, 909 F.2d 1101 (8th Cir., 1990) (railroad rolling stock subject to a lease not eligible).

[70] See Fairbanks v. U.S., 306 U.S. 436 (1039); Comm'r v. Pittston Co., 252 F. 2d 344 (2nd Cir.), cert. denied, 357 U.S. 919 (1958).

[71] A "section 1256 contract" means (1) any regulated futures contract, (2) foreign currency contract, (3) nonequity option, or (4) dealer equity option.

capital asset in the hands of the taxpayer. Section 1234A does not apply to the retirement of a debt instrument.

Character of gain on retirement of debt obligations.--Amounts received on the retirement of any debt instrument are treated as amounts received in exchange therefor (sec. 1271(a)(1)). In addition, gain on the sale or exchange of a debt instrument with OID[72] generally is treated as ordinary income to the extent of its OID if there was an intention at the time of its issuance to call the debt instrument before maturity (sec. 1271(a)(2)). These rules do not apply to (1) debt issued by a natural person or (2) debt issued before July 2, 1982, by a noncorporate or nongovernment issuer.

Description of Proposal

Extension of relinquishment rule to all types of property.--The proposal would extend the rule which treats gain or loss from the cancellation, lapse, expiration, or other termination of a right or obligation which is (or on acquisition would be) a capital asset in the hands of the taxpayer to all types of property.

Character of gain on retirement of debt obligations issued by natural persons.--The proposal would repeal the provision that exempts debt obligations issued by natural persons from the rule which treats gain realized on retirement of the debt as exchanges. Thus, under the proposal, gain or loss on the retirement of such debt will be capital gain or loss. The proposal would retain the present-law exceptions for debt issued before July 2, 1982, by noncorporations or nongovernments.

Effective Date

Extension of relinquishment rule to all types of property.--The extension of the extinguishment rule would apply to property acquired or positions established 30 day after the date of enactment of the proposal.

Character of gain on retirement of debt obligations issued by natural persons.--The repeal of the exception to the character of gain on retirement of debt instruments issued by natural persons or obligations issued before July 2, 1982, would apply to debt issued or purchased after June 8, 1997.

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[72] The issuer of a debt instrument with OID generally accrues and deducts the discount, as interest, over the life of the obligation even though the amount of such interest is not paid until the debt matures. The holder of such a debt instrument also generally includes the OID in income as it accrues as interest on an accrual bases. The mandatory inclusion of OID in income does not apply, among other exceptions, to debt obligations issued by natural persons before March 2, 1984, and loans of less than $10,000 between natural persons if such loan is not made in the ordinary course of business of the lender (secs. 1272(a)(2)(D) and (E)).

21. Interest on underpayment reduced by foreign tax credit carryback

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. Separate limitations are applied to specific categories of income. The amount of creditable taxes paid or accrued in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and carried forward five years.

For purposes of the computation of interest on overpayments of tax, if an overpayment for a taxable year results from a foreign tax credit carryback from a subsequent taxable year, the overpayment is deemed not to arise prior to the filing date for the subsequent taxable year in which the foreign taxes were paid or accrued (sec. 6611(g)). Accordingly, interest does not accrue on the overpayment prior to the filing date for the year of the carryback that effectively created such overpayment. In Fluor Corp. v. United States, 35 Fed. Cl. 520 (1996), the court held that in the case of an underpayment of tax (rather than an overpayment) for a taxable year that is eliminated by a foreign tax credit carryback from a subsequent taxable year, interest does not accrue on the underpayment that is eliminated by the foreign tax credit carryback. The Government has filed an appeal in the Fluor case.

Description of Proposal

Under the proposal, if an underpayment for a taxable year is reduced or eliminated by a foreign tax credit carryback from a subsequent taxable year, such carryback would not affect the computation of interest on the underpayment for the period ending with the filing date for such subsequent taxable year in which the foreign taxes were paid or accrued. The proposal also would clarify the application of the interest rules of both section 6601 and section 6611 in the case of a foreign tax credit carryback that is triggered by a net operating loss or net capital loss carryback; in such a case, a deficiency would not be considered to have been reduced, and an overpayment would not be considered to have been created, until the filing date for the subsequent year in which the loss carryback arose. No inference would be intended regarding the computation of interest under present law in the case of a foreign tax credit carryback (including a foreign tax credit carryback that is triggered by a net operating loss or net capital loss carryback).

Effective Date

The proposal would be effective for foreign taxes actually paid or accrued in taxable years beginning after date of enactment.

22. Election to receive taxable cash compensation in lieu of nontaxable parking benefits

Present Law

Under present law, up to $165 per month of employer-provided parking is excludable from gross income. In order for the exclusion to apply, the parking must be provided in addition to and not in lieu of any compensation that is otherwise payable to the employee. Employer-provided parking cannot be provided as part of a cafeteria plan.

Description of Proposal

Under the proposal, no amount would be includible in the income of an employee merely because the employer offers the employee a choice between cash and employer-provided parking. The amount of cash offered would be includible in income only if the employee chooses the cash instead of parking.

Effective Date

The proposal would be effective with respect to taxable years beginning after the date of enactment.

23. Allocation of basis of properties distributed to a partner by a partnership

Present Law

In general

The partnership provisions of present law generally permit partners to receive distributions of partnership property without recognition of gain or loss (sec. 731).[73] Rules are provided for determining the basis of the distributed property in the hands of the distributee, and for allocating basis among multiple properties distributed, as well as for determining adjustments to the distributee partner's basis in its partnership interest. Property distributions are tax-free to a partnership. Adjustments to the basis of the partnership's remaining undistributed assets are not

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[73] Exceptions to this nonrecognition rule apply: (1) when money (and the fair market value of marketable securities) received exceeds a partner's adjusted basis in the partnership (sec. 731(a)(1)); (2) when only money, inventory and unrealized receivables are received in liquidation of a partner's interest and loss is realized (sec. 731(a)(2)); (3) to certain disproportionate distributions involving inventory and unrealized receivables (sec. 751(b)); and (4) to certain distributions relating to contributed property (secs. 704(c) and 737). In addition, if a partner engages in a transaction with a partnership other than in its capacity as a member of the partnership, the transaction generally is considered as occurring between the partnership and one who is not a partner (sec. 707).

required unless the partnership has made an election that requires basis adjustments both upon partnership distributions and upon transfers of partnership interests (sec. 754).

Partner's basis in distributed properties and partnership interest

Present law provides two different rules for determining a partner's basis in distributed property, depending on whether or not the distribution is in liquidation of the partner's interest in the partnership. Generally, a substituted basis rule applies to property distributed to a partner in liquidation. Thus, the basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction) (sec. 732(b)).

By contrast, generally, a carryover basis rule applies to property distributed to a partner other than in liquidation of its partnership interest, subject to a cap (sec. 732(a)). Thus, in a non-liquidating distribution, the distributee partner's basis in the property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction). In a non-liquidating distribution, the partner's basis in its partnership interest is reduced by the amount of the basis to the distributee partner of the property distributed and is reduced by the amount of any money distributed (sec. 733).

Allocating basis among distributed properties

In the event that multiple properties are distributed by a partnership, present law provides allocation rules for determining their bases in the distributee partner's hands. An allocation rule is needed when the substituted basis rule for liquidating distributions applies, in order to assign a portion of the partner's basis in its partnership interest to each distributed asset. An allocation rule is also needed in a non-liquidating distribution of multiple assets when the total carryover basis would exceed the partner's basis in its partnership interest, so a portion of the partner's basis in its partnership interest is assigned to each distributed asset.

Present law provides for allocation in proportion to the partnership's adjusted basis. The rule allocates basis first to unrealized receivables and inventory items in an amount equal to the partnership's adjusted basis (or if the allocated basis is less than partnership basis, then in proportion to the partnership's basis), and then among other properties in proportion to their adjusted bases to the partnership (sec. 732(c)).[74] Under this allocation rule, in the case of a

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[74] A special rule allows a partner that acquired a partnership interest by transfer within two years of a distribution to elect to allocate the basis of property received in the distribution as if the partnership had a section 754 election in effect (sec. 732(d)). The special rule also allows the Service to require such an allocation where the value at the time of transfer of the property received exceeds 110 percent of its adjusted basis to the partnership (sec. 732(d)). Treas. Reg. sec. 1.732-1(d)(4) generally requires the application of section 732(d) where the allocation of

liquidating distribution, the distributee partner can have a basis in the distributed property that exceeds that partnership's basis in the property.

Description of Proposal

The proposal would modify the basis allocation rules for distributee partners. It would allocate a distributee partner's basis adjustment among distributed assets first to unrealized receivables and inventory items in an amount equal to the partnership's basis in each such property (as under present law). Under the proposal, any remaining basis would be allocated first to the extent of each distributed property's adjusted basis to the partnership. Any remaining basis adjustment, if an increase, would be allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), and then in proportion to their respective fair market values. If the remaining basis adjustment is a decrease, it would be allocated among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (to the extent of each property's depreciation), and then in proportion to their respective adjusted bases (taking into account the adjustments already made).

Effective Date

The proposal would apply to partnership distributions after the date of enactment.

24. Treatment of inventory items of a partnership

Present Law

Under present law, upon the sale or exchange of a partnership interest, any amount received that is attributable to unrealized receivables, or to inventory that has substantially appreciated, is treated as an amount realized from the sale or exchange of property that is not a capital asset (sec. 751(a)).

Present law provides a similar rule to the extent that a distribution is treated as a sale or exchange of a partnership interest. A distribution by a partnership in which a partner receives substantially appreciated inventory or unrealized receivables in exchange for its interest in certain other partnership property (or receives certain other property in exchange for its interest in substantially appreciated inventory or unrealized receivables) is treated as a taxable sale or exchange of property, rather than as a nontaxable distribution (sec. 751(b)).

For purposes of these rules, inventory of a partnership generally is treated as substantially appreciated if the fair market value of the inventory exceeds 120 percent of adjusted basis of the

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basis under section 732(c) upon a liquidation of the partner's interest would have resulted in a shift of basis from non-depreciable property to depreciable property.

inventory to the partnership (sec. 751(d)(1)(A)). In applying this rule, inventory property is excluded from the calculation if a principal purpose for acquiring the inventory property was to avoid the rules relating to inventory (sec. 751(d)(1)(B)).

Description of Proposal

The proposal would eliminate the requirement that inventory be substantially appreciated in order to give rise to ordinary income under the rules relating to sales and exchanges of partnership interests and certain partnership distributions.[75] This would conform the treatment of inventory to the treatment of unrealized receivables under these rules.

Effective Date

The proposal would be effective for sales, exchanges, and distributions after the date of enactment.

25. Extend UBIT rules to second-tier subsidiaries and amend control test

Present Law

In general, interest, rents, royalties and annuities received by tax-exempt organizations are not subject to the unrelated business income tax (UBIT). However, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as potentially subject to UBIT if such income is received from a taxable or tax-exempt subsidiary that is 80 percent controlled by the parent tax-exempt organization.[76] Rent, royalty, annuity, and interest payments received from a controlled subsidiary are treated as unrelated business income (UBTI) in the hands of the parent organization based on the percentage of the subsidiary's income that is unrelated business taxable income (either in the hands of the subsidiary if the subsidiary is tax-exempt, or in the hands of the parent organization if the subsidiary is taxable).

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[75] The ALI study on partnership rules referred to the substantial appreciation requirement as subject to manipulation and tax planning (American Law Institute, Federal Income Tax Project: Subchapter K: Proposals on the Taxation of Partners (R. Cohen, reporter, 1984), at 26. In 1993, the definition of substantially appreciated inventory was modified, and the present-law test relating to a principal purpose of avoidance was added (Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, sec. 13206(e)(1)). Nevertheless, the substantial appreciation requirement is still criticized as largely ineffective on at least two grounds (McKee, Nelson and Whitmire, Federal Taxation of Partners and Partnerships, supra, sec. 16.04[2]: (1) that it applies only to inventory items and not unrealized receivables and so does not insulate most partnerships from section 751; and (2) it may operate to exclude large amounts of ordinary income from section 751 if the partnership's profit margin is below 20 percent.

[76] For this purpose, a "controlled organization" is defined under section 368(c).

In the case of a stock subsidiary, the 80 percent control test under section 512(b)(13) is met if the parent organization owns 80 percent or more of the voting stock and all other classes of stock of the subsidiary.[77] In the case of a non-stock subsidiary, the applicable Treasury regulations look to factors such as the representation of the parent corporation on the board of directors of the nonstock subsidiary, or the power of the parent corporation to appoint or remove the board of directors of the subsidiary.[78]

The control test under section 512(b)(13) does not, however, incorporate any indirect ownership rules.[79] Consequently, rents, royalties, annuities and interest derived from second-tier subsidiaries generally do not constitute UBTI to the tax-exempt parent organization.[80]

Description of Proposal

The proposal would modify the test for determining control for purposes of section 512(b)(13). Under the proposal, "control" would mean (in the case of a stock corporation) ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control would mean ownership of more than 50 percent of the profits, capital or beneficial interests.

In addition, the proposal would apply the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization would be deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

The proposal also would make technical modifications to the method provided in section 512(b)(13) for determining how much of an interest, rent, annuity, or royalty payment made by a

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[77] Treas. reg. sec. 1.512(b)-1(l)(4)(I)(a).

[78] Treas. reg. sec. 1.512(b)-l(1)(4)(I)(b).

[79] See PLR 9338003 (June 16, 1993) (holding that because no indirect ownership rules are applicable under section 512(b)(13), rents paid by a second-tier taxable subsidiary are not UBTI to a tax-exempt parent organization). In contrast, an example of an indirect ownership rule can be found in Code section 318. Section 318(a)(2)(C) provides that if 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly by or for such corporation, in the proportion the value of the person's stock ownership bears to the total value of all stock in the corporation.

[80] See PLR 9542045 (July 28, 1995) (holding that first-tier holding company and second-tier operating subsidiary were organized with bona fide business functions and were not agents of the tax-exempt parent organization; therefore, rents, royalties, and interest received by tax-exempt parent organization from second-tier subsidiary were not UBTI).

controlled entity to a tax-exempt organization is includible in the latter organization's UBTI. Such payments would be subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity.

Effective Date

The modification of the control test to one based on vote or value, the application of the constructive ownership rules of section 318, and the technical modifications to the flow-through method would apply to taxable years beginning after the date of enactment. The reduction of the ownership threshold for purposes of the control test from 80 percent to more than 50 percent would apply to taxable years beginning after December 31, 1998.

26. Limitation on increase in basis of property resulting from sale by tax-exempt entity to related person

Present law

If a tax-exempt entity transfers assets to a controlled taxable entity in a transaction that is treated as a sale, the transferee taxable entity obtains a fair market value basis in the assets. Because the transferor is tax-exempt, no gain is recognized on the transfer except to the extent of certain unrelated business taxable income, if any.

Other provisions of the Code deny certain tax benefits when a transferor and transferee are related parties. For example, losses on sales between related parties are not recognized (sec. 267).

Description of Proposal

In the case of a sale or exchange of property directly or indirectly between a tax-exempt entity and a related person, the basis of the related person in the property would not exceed the adjusted basis of such property immediately before the sale in the hands of the tax-exempt entity, increased by the amount of any gain recognized to the tax exempt entity under the unrelated business taxable income rules of section 511.

Related person would mean any person having a relationship to the tax-exempt entity described in section 267(b) or 707(b)(1) (generally, certain more-than-50-percent relationships, with specified attribution rules). For purposes of applying section 267(b)(2), such an entity would be treated as if it were an individual.

Effective Date

The provision would apply to sales or exchanges after June 8, 1997; except that it would not apply to a sale or exchange made pursuant to a written agreement which was binding on such date and at all times thereafter.

27. Expand the limitations on deductibility of premiums and interest with respect to life insurance, endowment and annuity contracts

Present Law

Exclusion of inside buildup and amounts received by reason of death

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup").[81] Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured (sec. 101(a)).

Premium deduction limitation

No deduction is permitted for premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy (sec. 264(a)(1)).

Interest deduction disallowance with respect to life insurance

Present law provides generally that no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance contracts or annuity or endowment contracts owned by the taxpayer covering any individual who is or was (1) an officer or employee of, or (2) financially interested in, any trade or business currently or formerly carried on by the taxpayer (the "COLI" rules).

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[81] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than 7 annual level premiums (sec. 7702A). Certain amounts received under a life insurance contract on the life of a terminally or chronically ill individual, and certain amounts paid for the sale or assignment to a viatical settlement provider of a life insurance contract on the life of a terminally ill or chronically ill individual, are treated as excludable as if paid of the death of the insured (sec. 101(g)).

This interest deduction disallowance rule generally does not apply to interest on debt with respect to contracts purchased on or before June 20, 1986; rather, an interest deduction limit based on Moody's Corporate Bond Yield Average--Monthly Average Corporates applies in the case of such contracts.[82]

An exception to this interest disallowance rule is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) 5 individuals, or (2) the lesser of 5 percent of the total number of officers and employees of the taxpayer, or 20 individuals. For determining who is a 20-percent owner, all members of a controlled group are treated as one taxpayer. Interest paid or accrued on debt with respect to a contract covering a key person is deductible only to the extent the rate of interest does not exceed Moody's Corporate Bond Yield Average - Monthly Average Corporates for each month beginning after December 31, 1995, that interest is paid or accrued.

The foregoing interest deduction limitation was added in 1996 to existing interest deduction limitations with respect to life insurance and similar contracts.[83]

Interest deduction limitation with respect to tax-exempt interest income

Present law provides that no deduction is allowed for interest on debt incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax (sec. 265(a)(2)). In addition, in the case a financial institution, a proration rule provides that no deduction is allowed for that portion of the taxpayer's interest that is allocable to tax-exempt

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[82] Phase-in rules apply generally with respect to otherwise deductible interest paid or accrued after December 31, 1995, and before January 1, 1999, in the case of debt incurred before January 1, 1996. In addition, transition rules apply.

[83] Since 1942, a limitation has applied to the deductibility of interest with respect to single premium contracts (sec. 264(a)(2)). For this purpose, a contract is treated as a single premium contract if (1) substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased, or (2) an amount is deposited with the insurer for payment of a substantial number of future premiums on the contract. Further, under a limitation added in 1964, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, endowment, or annuity contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (sec. 264(a)(3)). An exception to the latter rule is provided, permitting deductibility of interest on bona fide debt that is part of such a plan, if no part of 4 of the annual premiums due during the first 7 years is paid by means of debt (the "4-out-of-7 rule") (sec. 264(c)(1)). In addition to the specific disallowance rules of section 264, generally applicable principles of tax law apply.

interest (sec. 265(b)). The portion of the interest deduction that is disallowed under this rule generally is the portion determined by the ratio of the taxpayer's (1) average adjusted bases of tax-exempt obligations acquired after August 7, 1986, to (2) the average adjusted bases for all of the taxpayer's assets (sec. 265(b)(2)).[84]

Description of Proposal

Expansion of premium deduction limitation to individuals in whom taxpayer has an insurable interest

Under the proposal, the present-law premium deduction limitation would be modified to provide that no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.

Expansion of interest disallowance to individuals in whom taxpayer has insurable interest

Under the proposal, no deduction would be allowed for interest paid or accrued on any indebtedness with respect to life insurance policy, or endowment or annuity contract, covering the life of any individual. Thus, the proposal would limit interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest when the contract is first issued under applicable State law, except as otherwise provided under present law with respect to key persons and pre-1986 contracts.

Pro rata disallowance of interest on debt to fund life insurance

In the case of a taxpayer other than a natural person, no deduction would be allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values with respect to any life insurance policy or annuity or endowment contract issued after June 8, 1997. Interest expense would be so allocable based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance policies, and annuity and endowment contracts, issued after June 8, 1997, to (2) the average adjusted bases for all assets of the taxpayer. This rule would not apply to any policy or contract owned by an entity engaged in a trade or business, covering any individual who is an employee, officer or director of the trade or business at the time first covered by the policy or contract. Such a policy or contract would not be taken into account in determining unborrowed policy cash values.

If a trade or business (other than a sole proprietorship or a trade or business of performing services as an employee) is directly or indirectly the beneficiary under any policy or contract, then the policy or contract would be treated as held by the trade or business. For this purpose, the amount of the unborrowed cash value would be treated as not exceeding the amount of the benefit

[84] Special rules apply for certain tax-exempt obligations of small issuers (sec. 265(b)(3)).

payable to the trade or business. In the case of a partnership or S corporation, the proposal would apply at the partnership or corporate level.

As provided in regulations, the issuer or policyholder of the life insurance policy or endowment or annuity contract would be required to report the amount of the amount of the unborrowed cash value in order to carry out this rule.

If interest expense is disallowed under other rules limiting interest deductions with respect to life insurance policies or endowment or annuity contracts or tax-exempt interest, then the disallowed interest expense would not be taken into account under this proposal, and the average adjusted bases of assets is reduced by the amount of debt, interest on which is so disallowed. The proposal is applied before present-law rules relating to capitalization of certain expenses where the taxpayer produces property.

An aggregation rule is provided, treating related persons as one for purposes of the proposal.

The proposal would not apply to any insurance company subject to tax under subchapter L of the Code. Rather, the rules reducing certain deductions for losses incurred, in the case of property and casualty companies, and reducing reserve deductions or dividends received deductions of life insurance companies, would be modified to take into account the increase in cash values of life insurance policies or annuity or endowment contracts held by insurance companies.

Effective Date

The proposals would apply with respect to contracts issued after June 8, 1997. For this purpose, a material increase in the death benefit or other material change in the contract would cause the contract to be treated as a new contract. To the extent of additional covered lives under a contract after June 8, 1997, the contract would be treated as a new contract. In the case of an increase in the death benefit of a contract that is converted to extended term insurance pursuant to nonforfeiture provisions, in a transaction to which section 501(d)(2) of the Health Insurance Portability and Accountability Act of 1996 applies, the contract would not be treated as a new contract.

28. Phase out suspense accounts for certain large farm corporations

Present Law

A corporation (or a partnership with a corporate partner) engaged in the trade or business of farming must use an accrual method of accounting for such activities unless such corporation (or partnership), for each prior taxable year beginning after December 31, 1975, did not have gross receipts exceeding $1 million. If a farm corporation is required to change its method of accounting, the section 481 adjustment resulting from such change is included in gross income ratably over a 10-year period, beginning with the year of change. This rule does not apply to a family farm corporation.

A provision of the Revenue Act of 1987 ("1987 Act") requires a family corporation (or a partnership with a family corporation as a partner) to use an accrual method of accounting for its farming business unless, for each prior taxable year beginning after December 31, 1985, such corporation (and any predecessor corporation) did not have gross receipts exceeding $25 million. A family corporation is one where at 50 percent or more of the stock of the corporation is held by one (or in some limited cases, two or three) families.

A family farm corporation that must change to an accrual method of accounting as a result of the 1987 Act provision is to establish a suspense account in lieu of including the entire amount of the section 481 adjustment in gross income. The initial balance of the suspense account equals the lesser of (1) the section 481 adjustment otherwise required for the year of change, or (2) the section 481 adjustment computed as if the change in method of accounting had occurred as of the beginning of the taxable year preceding the year of change.

The amount of the suspense account is required to be included in gross income if the corporation ceases to be a family corporation. In addition, if the gross receipts of the corporation attributable to farming for any taxable year decline to an amount below the lesser of (1) the gross receipts attributable to farming for the last taxable year for which an accrual method of accounting was not required, or (2) the gross receipts attributable to farming for the most recent taxable year for which a portion of the suspense account was required to be included in income, a portion of the suspense account is required to be included in gross income.

Description of Proposal

The proposal would repeal the ability of a family farm corporation to establish a suspense account when it is required to change to an accrual method of accounting. Thus, under the proposal, any family farm corporation required to change to an accrual method of accounting would restore the section 481 adjustment applicable to the change in gross income ratably over a 10-year period beginning with the year of change.

In addition, any taxpayer with an existing suspense account would be required to restore the account into income ratably over a 20-year period beginning in the first taxable year beginning after June 8, 1997, subject to the present-law requirements to restore such accounts more rapidly. In no event would the amount required to be restored to income for a taxable year pursuant to the 20-year spread period exceed the net operating loss of the corporation for the year or 50 percent of the net income of the taxpayer for the year (determined without regard to the amount restored to income under the proposal). Any reduction in the amount required to be restored to income would be taken into account ratably over the remaining years in the 20-year period or, if applicable, after the end of the 20-year period.

Effective Date

The proposal would be effective for taxable years ending after June 8, 1997.

29. Repeal of exception for certain sales by manufacturers to dealers

Present Law

In general, the installment sales method of accounting may not be used by dealers in personal property. Present law provides an exception which permits the use of the installment method for installment obligations arising from the sale of tangible personal property by a manufacturer of the property (or an affiliate of the manufacturer) to a dealer,[85] but only if the dealer is obligated to make payments of principal only when the dealer resells (or rents) the property, the manufacturer has the right to repurchase the property at a fixed (or ascertainable) price after no longer than a nine month period following the sale to the dealer, and certain other conditions are met. In order to meet the other conditions, the aggregate face amount of the installment obligations that otherwise qualify for the exception must equal at least 50 percent of the total sales to dealers that gave rise to such receivables (the "fifty percent test") in both the taxable year and the preceding taxable year, except that, if the taxpayer met all of the requirements for the exception in the preceding taxable year, the taxpayer would not be treated as failing to meet the fifty percent test before the second consecutive year in which the taxpayer did not actually meet the test. For purposes of applying the fifty percent test, the aggregate face amount of the taxpayer's receivables is computed using the weighted average of the taxpayer's receivables outstanding at the end of each month during the taxpayer's taxable year. In addition, these requirements must be met by the taxpayer in its first taxable year beginning after October 22, 1986, except that obligations issued before that date are treated as meeting the applicable requirements if such obligations were conformed to the requirements of the provision within 60 days of that date.

Description of Proposal

The proposal would repeal the exception that permits the use of the installment method of accounting for certain sales by manufacturers to dealers.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment. If a taxpayer is required to change its method of accounting under the proposal, such change would be treated as initiated by the taxpayer with the consent of the Secretary of the Treasury and any section 481 adjustment would be included in income ratably over a four-year period.

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[85] I.e., the sale of the property must be intended to be for resale or leasing by the dealer.

30. Repeal grandfather rule with respect to pension business of insurer

Present Law

Present law provides that an organization described in sections 501(c)(3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. When this rule was enacted in 1986, certain treatment (described below) applied to Blue Cross and Blue Shield organizations providing health insurance that (1) were in existence on August 16, 1986; (2) were determined at any time to be tax-exempt under a determination that had not been revoked; and (3) were tax-exempt for the last taxable year beginning before January 1, 1987 (when the present-law rule became effective), provided that no material change occurred in the structure or operations of the organizations after August 16, 1986, and before the close of 1986 or any subsequent taxable year.

The treatment applicable to such organizations, which became taxable organizations under the provision, is as follows. A special deduction applies with respect to health business equal to 25 percent of the claims and expenses incurred during the taxable year less the adjusted surplus at the beginning of the year. An exception is provided for such organizations from the application of the 20-percent reduction in the deduction for increases in unearned premiums that applies generally to property and casualty insurance companies. A fresh start was provided with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status. Thus, no adjustment was made under section 481 on account of an accounting method change. Such an organization was required to compute its ending 1986 loss reserves without artificial changes that would reduce 1987 income. Thus, any reserve weakening after August 16, 1986 was treated as occurring in the organization's first taxable year beginning after December 31, 1986. The basis of such an organization's assets was deemed to be equal to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after December 31, 1986, for purposes of determining gain or loss (but not for determining depreciation or for other purposes).

Grandfather rules were provided in the 1986 Act relating to the provision. It was provided that the provision does not apply with respect to that portion of the business of Mutual of America which is attributable to pension business. Pension business means the administration of any plan described in section 401(a) of the Code which includes a trust exempt from tax under section 501(a), and plan under which amounts are contributed by an individual's employer for an annuity contract described in section 403(b) of the Code, any individual retirement plan described in section 408 of the Code, and any eligible deferred compensation plan to which section 457(a) of the Code applies.

Description of Proposal

The proposal would repeal the grandfather rule applicable to that portion of the business of Mutual of America which is attributable to pension business. Mutual of America would be treated for Federal tax purposes as a life insurance company. A fresh start would be provided with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status.

Thus, no adjustment would be made under section 481 on account of an accounting method change. Mutual of America would be required to compute ending 1997 loss reserves without artificial changes that would reduce 1998 income. Thus, any reserve weakening after June 8, 1997, would be treated as occurring in the organization's first taxable year beginning after December 31, 1997. The basis of assets of Mutual of America would be deemed to be equal to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after December 31, 1997, for purposes of determining gain or loss (but not for determining depreciation or for other purposes).

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

31. Application of communications tax to long-distance prepaid telephone cards

Present Law

A 3-percent excise tax is imposed on amounts paid for local and toll (long-distance) telephone service and teletypewriter exchange service. The tax is collected by the provider of the service from the consumer (business and personal service).

Description of Proposal

The proposal would provide that any amounts paid to communications service providers (in cash or in kind) for the right to award or otherwise distribute free or reduced-rate long-distance telephone service are treated as amounts paid for taxable communication services, subject to the 3-percent ad valorem tax rate. Examples of such taxable amounts include (1) prepaid telephone cards offered through service stations, convenience stores and other businesses to their customers and others (e.g., employees) and (2) amounts received by communication service providers pursuant to joint venture credit card or other marketing arrangements. The Treasury Department is authorized specifically to disregard accounting allocations or other arrangements which have the effect of reducing artificially the base to which the 3-percent tax is applied. No inference is intended from this proposal as to the proper treatment of these payments under present law.

Effective Date

The proposal would be effective for amounts paid on or after the date of enactment.

32. Consistency rule for beneficiaries of trusts and estates

Present Law

An S corporation is required to file a return for the taxable year and is required to furnish to its shareholders a copy of certain information shown on such return. The shareholder is required to file its return in a manner that is consistent with the information received from the S corporation, unless the shareholder files with the Secretary of the Treasury a notification of inconsistent treatment (sec. 6037(c)). Similar rules apply in the case of partnerships and their partners (sec. 6222).

The fiduciary of an estate or trust that is required to file a return for any taxable year is required to furnish to beneficiaries certain information shown on such return (generally via a Schedule K-1) (sec.6034A). In addition, a U.S. person that is treated as the owner of any portion of a foreign trust is required to ensure that the trust files a return for the taxable year and furnishes certain required information to each U.S. person who is treated as an owner of a portion of the trust or who receives any distribution from the trust (sec. 6048(b)). However, rules comparable to the consistency rules that apply to S corporation shareholders and partners in partnerships are not specified in the case of beneficiaries of estates and trusts.

Description of Proposal

Under the proposal, a beneficiary of an estate or trust would be required to file its return in a manner that is consistent with the information received from the estate or trust, unless the beneficiary files with its return a notification of inconsistent treatment identifying the inconsistency.

Effective Date

The proposal would be effective for returns filed after date of enactment.

33. Information returns on real estate transactions

Present Law

Persons who close real estate transactions are required to file information returns with the IRS. There returns, filed on Form 1099S, are required to show the name and address of the buyer and seller of the real estate, details with regard to the gross proceeds of the sale, and the portion of any real property tax which is treated as a tax imposed on the purchaser. Code section 6045 also provides for reporting whether any financing of the seller was federally-subsidized indebtedness, but Treasury regulations do not currently require the reporting of this information.

Description of Proposal

The proposal would exclude sales of personal residences with a gross sales price of $500,000 or less ($250,000 or less in the case of a seller whose filing status is not married, filing jointly) from the real estate transaction reporting requirement, provided the person who would otherwise be required to file the information return obtains written assurances from the seller of the real estate that any gain will be exempt from Federal income tax under section 121 and that no financing of the seller was federally-subsidized indebtedness. The requirement that the person settling the transaction obtain written assurances for the seller of the real estate that none of his financing was federally-subsidized indebtedness would be suspended until such time as this information is otherwise required by the Secretary of the Treasury to be included in information returns reporting real estate transactions.

Effective Date

The proposal would be effective for information returns otherwise required with regard to real estate sales occurring after the date of enactment.

34. Determination of period of limitations relating to foreign tax credits

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. Separate limitations are applied to specific categories of income. The amount of creditable taxes paid or accrued in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and carried forward five years.

For purposes of the period of limitations on filing claims for credit or refund, in the case of a claim relating to an overpayment attributable to foreign tax credits, the limitations period is ten years from the filing date for the taxable year with respect to which the claim is made. The Internal Revenue Service has taken the position that, in the case of a foreign tax credit carryforward, the period of limitations is determined by reference to the year in which the foreign taxes were paid or accrued (and not the year to which the foreign tax credits are carried) (Rev. Rul. 84-125, 1984-2 C.B. 125). However, the court in Ampex Corp. v. United States, 620 F.2d 853 (1980), held that, in the case of a foreign tax credit carryforward, the period of limitations is determined by reference to the year to which the foreign tax credits are carried (and not the year in which the foreign taxes were paid or accrued).

Description of Proposal

Under the proposal, in the case of a claim relating to an overpayment attributable to foreign tax credits, the limitations period would be determined by reference to the year in which the foreign taxes were actually paid or accrued (and not the year to which the foreign tax credits are carried). No inference would be intended regarding the determination of such limitations period under present law.

Effective Date

The proposal would be effective for foreign taxes actually paid or accrued in taxable years beginning after date of enactment.

35. Modify rate structure of vaccine excise tax

Present Law

A manufacturer's excise tax is imposed (sec. 4131) on the following vaccines routinely recommended for administration to children: DPT (diphtheria, pertussis, tetanus,), $4.56 per dose; DT (diphtheria, tetanus), $0.06 per dose; MMR (measles, mumps, or rubella), $4.44 per dose; and polio, $0.29 per dose. In general, if any vaccine is administered by combining more than one of the listed taxable vaccines, the amount of tax imposed is the sum of the amounts of tax imposed for each taxable vaccine. However, in the case of MMR and its components, any component vaccine of MMR is taxed at the same rate as the MMR combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1998, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

Description of Proposal

The proposal would replace the present-law excise tax rates, that differ by vaccine, with a single rate tax of $0.84 per dose on any listed vaccine component. Thus, the proposal would provide that the tax applied to any vaccine that is a combination of vaccine components would be 84 cents times the number of components in the combined vaccine. For example, the MMR vaccine would be taxed at a rate of $2.52 per dose and the DT vaccine would be taxed at rate of $1.68 per dose.

In addition, the proposal would add three new taxable vaccines to the present-law taxable vaccines: (1) HIB (haemophilus influenza type B); (2) Hepatitis B; and (3) varicella (chickenpox). The three newly listed vaccines also would be subject to the 84-cents per dose excise tax.

Effective Date

The proposal would be effective for vaccine purchases after September 30, 1997. No tax would be collected or refunds permitted for amounts held for sale on October 1, 1997.

36. Cash out of certain accrued benefits

Present Law

Under present law, in the case of an employee whose plan participation terminates, a qualified plan may involuntarily "cash out" the benefit (i.e., pay out the balance to the credit of a plan participant without the participant's consent, and, if applicable, the consent of the participant's spouse) if the present value of the benefit does not exceed $3,500. If a benefit is cashed out under this rule and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which benefits were cashed out unless the employee "buys back" the benefit.

Generally, a cash-out distribution from a qualified plan to a plan participant can be rolled over, tax free, to an IRA or to another qualified plan.

Description of Proposal

The proposal would increase the limit on involuntary cash-outs to $5,000 from $3,500. The $5,000 amount would be adjusted annually for inflation beginning after 1997.

Effective Date

The proposal would be effective for plan years beginning on and after the date of enactment.

37. Repeal of excess distribution and excess retirement accumulation tax

Present Law

Under present law, the 15-percent excise tax on excess distributions from qualified retirement plans, tax-sheltered annuities, and IRAs is suspended with respect to distributions received in 1997, 1998, and 1999. Excess distributions are generally the aggregate amount of retirement distributions from such plans during any calendar year in excess of $160,000 (for 1997) or 5 times that amount in the case of a lump-sum distribution.

An additional 15-percent estate tax is imposed on an individual's excess retirement accumulations.

Description of Proposal

The proposal would repeal both the 15-percent excise tax on excess distributions and the 15-percent estate tax on excess retirement accumulations.

Effective Date

The proposal repealing the excess distribution tax would be effective with respect to excess distributions received after December 31, 1996. The repeal of the excess accumulation tax would be effective with respect to decedents dying after December 31, 1996.

38. Repeal special exception to foreign tax credit limitation for alternative minimum tax purposes

Present Law

Present law imposes a minimum tax on a corporation to the extent the taxpayer's minimum tax liability exceeds its regular tax liability. The corporate minimum tax is imposed at a rate of 20 percent on alternative minimum taxable income in excess of a phased-out $40,000 exemption amount.

The combination of the taxpayer's net operating loss carryover and foreign tax credits cannot reduce the taxpayer's alternative minimum tax liability by more than 90 percent of the amount determined without these items.

The Omnibus Budget Reconciliation Act of 1989 ("1989 Act") provided a special exception to the limitation on the use of the foreign tax credit against the tentative minimum tax. In order to qualify for this exception, a corporation must meet four requirements. First, more than 50 percent of both the voting power and value of the stock of the corporation must be owned by U.S. persons who are not members of an affiliated group which includes such corporation. Second, all of the activities of the corporation must be conducted in one foreign country with which the United States has an income tax treaty in effect and such treaty must provide for the exchange of information between such country and the United States. Third, the corporation generally must distribute to its shareholders all current earnings and profits (except for certain amounts utilized for normal maintenance or capital expenditures related to its existing business). Fourth, all of such distributions which are received by U.S. persons must be utilized by such persons in a U.S. trade or business. This exception applies to taxable years beginning after March 31, 1990 (with a proration rule effective for certain taxable years which include March 31, 1990).

Description of Proposal

The special exception regarding the use of foreign tax credits for purposes of the alternative minimum tax, as provided by the 1989 Act, would be repealed.

Effective Date

The proposal would be effective for taxable years beginning after date of enactment.

39. Modify treatment of tires under the heavy highway vehicle retail excise tax

Present Law

A 12-percent retail excise tax is imposed on certain heavy highway trucks and trailers, and on highway tractors. A separate manufacturers' excise tax is imposed on tires weighing more than 40 pounds. This tire tax is imposed as a fixed dollar amount which varies based on the weight of the tire. Because tires are taxed separately, the value of tires installed on a highway vehicle is excluded from the 12-percent excise tax on heavy highway vehicles. The determination of value is factual and has given rise to numerous tax audit challenges.

Description of Proposal

The current exclusion of the value of tires installed on a taxable highway vehicle would be repealed. Instead, a credit for the amount of manufacturers' excise tax actually paid on the tires would be allowed.

Effective Date

The proposal would be effective after December 31, 1997.